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Consommation
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Proposals for a Securities Market Law for Canada Volume 2

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Proposals for
a Securities Market
Law
for Canada

Volume 2
Commentary



Consumer and
Corporate Affairs
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et Corporations
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Proposals for a Securities Market Law for Canada

Volume 2 Commentary

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Table of Abbreviations

Used in This Work

This table lists, in the left-hand column, short forms for documents, reports and books that are frequently cited in *Proposals for a Securities Market Law for Canada*. Short forms for reports appear in large and small capital letters, thus: ALI FEDERAL SECURITIES CODE. The short form for books is given by author name in large and small capitals: L. Loss. Statutes and regulations are shown in upper and lower case Roman letters. Background papers in Volume 3 are cited by author name in italics.

Legislation

1. *Statutes*

CANADA

Alberta Securities Act	Alberta Securities Act, R.S.A. 1970, c. 333, as amended
Bank Act	Bank Act, R.S.C. 1970, c. B-1, as amended
British Columbia Securities Act	British Columbia Securities Act, S.B.C. 1967, c. 45, as amended

Canada Business Corporations Act	Canada Business Corporations Act, S.C. 1974-75, c. 33, as amended
Canada Corporations Act	Canada Corporations Act, R.S.C. 1970, c. C-32, as amended
Criminal Code	Criminal Code, R.S.C. 1970, c. C-34, as amended
Federal Court Act	Federal Court Act, R.S.C. 1970, 2d Supp., c. 10
Income Tax Act	Income Tax Act, S.C. 1970-71, c. 63, as amended
Interpretation Act	Interpretation Act, R.S.C. 1970, c. I-23
Manitoba Securities Act	Manitoba Securities Act, R.S.M. 1970, c. S50, as amended
New Brunswick Securities Act	New Brunswick Securities Frauds Prevention Act, R.S.N.B. 1973, c. S-6
Newfoundland Securities Act	Newfoundland Securities Act, R.S.N. 1970, c. 349, as amended
Northwest Territories Securities Ordinance	Northwest Territories Securities Ordinance, R.O.N.W.T. 1971, c. 17
Nova Scotia Securities Act	Nova Scotia Securities Act, R.S.N.S. 1967, c. 280, as amended
Ontario Business Corporations Act	Ontario Business Corporations Act, R.S.O. 1970, c. 53, as amended
Ontario Securities Act	Ontario Securities Act, R.S.O. 1970, c. 426, as amended

Ontario Bill 154	Bill 154, The Securities Act, 1972, Ontario, 29th Legis., 2d Sess. (First Reading, June 1, 1972)
Ontario Bill 75	Bill 75, The Securities Act, 1974, Ontario, 29th Legis., 4th Sess. (First Reading, June 7, 1974)
Ontario Bill 98	Bill 98, The Securities Act, 1975, Ontario, 29th Legis., 5th Sess. (First Reading, May 30, 1975)
Ontario Bill 20	Bill 20, The Securities Act, 1977, Ontario, 30th Legis., 4th Sess. (First Reading, April 5, 1977)
Ontario Bill 30	Bill 30, The Securities Act, 1977, Ontario, 31st Legis., 1st Sess. (First Reading, June 29, 1977)
Ontario Bill 7 (2d reading)	Bill 7, The Securities Act, 1978, Ontario, 31st Legis., 2d Sess. (Second Reading, April 6, 1978) (Reprinted for consideration by the Administration of Justice Committee)
Ontario Securities Act, 1978	Bill 7, The Securities Act, 1978, Ontario, 31st Legis., 2d Sess. (Third Reading, June 23, 1978)
Prince Edward Island Securities Act	Prince Edward Island Securities Act, R.S.P.E.I. 1974, c. S-4
Quebec Securities Act	Quebec Securities Act, R.S.Q. 1964, c. 274, as amended
Saskatchewan Securities Act	Saskatchewan Securities Act, 1967, S.S. 1967, c. 81, as amended
Telecommunications Act	Telecommunications Act, Bill C-24, 30th Parl., 3d Sess. (First Reading, January 26, 1978)

Yukon Securities Ordinance

Yukon Territories Securities
Ordinance, O.Y.T. 1971, c. 1

UNITED STATES

Administrative Procedure
Act

Administrative Procedure Act,
60 Stat. 237, 5 U.S.C., ss. 551-706

Investment Advisers Act
of 1940

Investment Advisers Act of
1940, 54 Stat. 847, 15 U.S.C., ss.
80b-1-80b-21

Investment Company Act
of 1940

Investment Company Act of
1940, 54 Stat. 789, 15 U.S.C., ss.
80a-1-80a-52

Securities Act of 1933

Securities Act of 1933, 48 Stat.
74, 15 U.S.C., ss. 77a-77aa

Securities Exchange Act
of 1934

Securities Exchange Act of 1934,
48 Stat. 881, 15 U.S.C.,
ss. 78a-78jj

Securities Reform Act
of 1975

Securities Acts Amendments
of 1975, 94 Pub. L. 29

2. *Regulations*

Alberta Securities
Regulations

Alberta Securities Regulations,
Alta. Reg. 80/72, as amended

British Columbia Securities
Regulations

British Columbia Securities
Regulations, B.C. Reg. 193/67,
as amended

Canada Business
Corporations Regulations

Canada Business Corporations
Act Regulations, SOR 75-682,
P.C. 1975-2820, Dec. 12, 1975,
as amended

Canada Corporations
Regulations

Canada Corporations Act
Regulations, SOR 76-22, P.C.
1975-3001, Jan. 14, 1976, as
amended

Manitoba Securities Regulations	Manitoba Securities Regulations, R.R. Man., Reg. S50-R1, as amended
Ontario Business Corporations Regulations	Ontario Business Corporations Regulations, R.R.O. 1970, Reg. 492/70, as amended
Ontario Securities Regulations	Ontario Securities Regulations, R.R.O. 1970, Reg. 794/70, as amended
Saskatchewan Securities Regulations	Saskatchewan Securities Regulations, Sask. Reg. 241/67, as amended

3. *Self-Regulatory*

ALI FEDERAL SECURITIES CODE	AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE, Proposed Official Draft (March 15, 1978) (L. Loss, Reporter)
ALI FEDERAL SECURITIES CODE, Tent. Drafts Nos. 1-6	AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE, Tent. Drafts Nos. 1-6 (1972-77) (L. Loss, Reporter)
ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3	AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE, Reporter's Revision of Text of Tent. Drafts Nos. 1-3 (1974) (L. Loss, Reporter)

Government Documents

1 *Reports*

CANADA

BUSINESS CORPORATIONS PROPOSALS	R. DICKERSON, J. HOWARD & L. GETZ, PROPOSALS FOR A NEW BUSINESS CORPORATIONS LAW FOR CANADA, vol. I, Commentary; vol. II, Draft Act (1971)
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CANADIAN MUTUAL FUND
REPORT

REPORT OF THE CANADIAN COMMIT-
TEE ON MUTUAL FUNDS AND
INVESTMENT CONTRACTS (1969)

KIMBER REPORT

REPORT OF THE ATTORNEY-GENER-
AL'S COMMITTEE ON SECURITIES
LEGISLATION IN ONTARIO
(J.R. Kimber, chairman, 1965)

MUTUAL FUND PROPOSALS

J. BAILLIE & W. GROVER,
PROPOSALS FOR A MUTUAL FUND
LAW FOR CANADA (vols. 1-2,
1974) (Consumer and Corporate
Affairs Canada)

ONTARIO SECURITIES
COMMISSION
DISCLOSURE REPORT

ONTARIO SECURITIES COMMISSION,
REPORT OF THE COMMITTEE OF THE
ONTARIO SECURITIES COMMISSION
ON THE PROBLEMS OF DISCLOSURE
RAISED FOR INVESTORS BY BUSINESS
COMBINATIONS AND PRIVATE
PLACEMENTS (1970)

PARIZEAU REPORT

REPORT OF THE STUDY COMMITTEE
ON FINANCIAL INSTITUTIONS
(Jacques Parizeau, chairman,
Québec, 1969)

PORTER REPORT

REPORT OF THE ROYAL COMMISSION
ON BANKING AND FINANCE
(Dana Porter, chairman, 1964)

WINDFALL REPORT

REPORT OF THE ROYAL COMMISSION
TO INVESTIGATE TRADING IN THE
SHARES OF WINDFALL OILS AND
MINES LIMITED (Ontario, 1965)

UNITED STATES

INSTITUTIONAL INVESTOR
REPORT

SECURITIES AND EXCHANGE COMMIS-
SION, INSTITUTIONAL INVESTOR
STUDY REPORT, 92d Cong., 1st
Sess., House Doc. No. 92-64
(5 vols., 1971)

SPECIAL STUDY REPORT

SECURITIES AND EXCHANGE
COMMISSION, REPORT OF SPECIAL
STUDY OF SECURITIES MARKETS
(parts 1-6, 1963)

WHEAT REPORT

DISCLOSURE TO INVESTORS: A RE-
APPRAISAL OF FEDERAL ADMINIS-
TRATIVE POLICIES UNDER THE '33
AND '34 ACTS (Francis M. Wheat,
commissioner, undated: 1969)

UNITED KINGDOM

RENTON REPORT

COMMITTEE APPOINTED BY THE
LORD PRESIDENT OF THE COUNCIL,
REPORT: THE PREPARATION OF
LEGISLATION, Cmnd. 6053
(Sir David Renton, chairman,
1975)

Texts

P. ANISMAN

P. ANISMAN, TAKEOVER BID
LEGISLATION IN CANADA (1974)

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THE SEVENTIES (1976)

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L. GOWER, THE PRINCIPLES OF
MODERN COMPANY LAW (3d ed.
1969)

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D. JOHNSTON, CANADIAN SECURI-
TIES REGULATION (1977)

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L. LOSS, SECURITIES REGULATION
(2d ed., vols. 1-3, 1961 & Supp.,
vols. 4-6, 1969)

J. WILLIAMSON

J. WILLIAMSON, SECURITIES
REGULATION IN CANADA (1960)

J. WILLIAMSON, SUPP.

J. WILLIAMSON, SECURITIES
REGULATION IN CANADA,
SUPPLEMENT (1966)

Article

<i>Anisman</i>	<i>Anisman, Insider Trading under the Canada Business Corporations Act</i> , in MEREDITH MEMORIAL LECTURES 1975: CANADA BUSINESS CORPORATIONS ACT 151 (1976)
----------------	--

Background Papers, Volume 3

<i>Anisman & Hogg</i>	<i>Anisman and Hogg, Constitutional Aspects of Federal Securities Legislation</i>
<i>Cleland</i>	<i>Cleland, Applications of Automation in the Canadian Securities Industry: Present and Projected</i>
<i>Connelly</i>	<i>Connelly, The Licensing of Securities Market Actors</i>
<i>Dey & Makuch</i>	<i>Dey and Makuch, Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry</i>
<i>Grover & Baillie</i>	<i>Grover and Baillie, Disclosure Requirements</i>
<i>Hall</i>	<i>Hall, Continuing Disclosure and Data Collection</i>
<i>Hebenton & Gibson</i>	<i>Hebenton and Gibson, International Aspects of Securities Legislation</i>
<i>Honsberger</i>	<i>Honsberger, Failures of Securities Dealers and Protective Devices</i>
<i>Howard</i>	<i>Howard, Securities Regulation: Structure and Process</i>

<i>Iacobucci</i>	<i>Iacobucci, The Definition of Security for Purposes of a Securities Act</i>
<i>Jenkins</i>	<i>Jenkins, Computer Communications Systems in Securities Markets</i>
<i>Leigh</i>	<i>Leigh, Securities Regulation: Problems in Relation to Sanctions</i>
<i>Williamson, Capital Markets</i>	<i>Williamson, Canadian Capital Markets</i>
<i>Williamson, Financial Institutions</i>	<i>Williamson, Canadian Financial Institutions</i>
<i>Yontef</i>	<i>Yontef, Insider Trading</i>

Erratum

In Volume 2 some footnote references to Volume 3 (*Background Papers*) are incorrect. The numeral after the chapter number should be changed to the equivalent alphabetical character and the subparagraph character should be changed from an alphabetical character to the equivalent numeral.

For example: *see, Williamson*, ch. II.8.A,
should read: ch. II.H.1.

Part 1

Policy of Act

In the past two decades a large number of reports on the functioning of financial markets, and particularly securities markets, have been published in Canada, both provincially and federally. Some have concerned themselves primarily with the working of provincial legislation either on a general basis or in relation to the investigation of particular fraudulent schemes.¹ Others have dealt with the capital markets or financial institutions on a broader basis.² While all such studies have made recommendations for the improvement of legislation regulating the securities market, the latter studies have also generally recognized that the financial market in Canada is Canada-wide in character.³ The Draft Act takes this fact as its starting point and incorporates it as the primary declaration in its purpose clause.⁴

Section 1.02 declares the policy of the Draft Act in terms of the function and functioning of the Canadian securities market and thus indicates the purpose of securities regulation generally, namely, to ensure investor confidence in an honest, fair and efficient market that will encourage savers to invest in securities and increase the liquidity of trading markets and the general effectiveness of the securities markets as a mechanism for allocating

1 See e.g. KIMBER REPORT; WINDFALL REPORT.

2 See e.g. PORTER REPORT; PARIZEAU REPORT.

3 See also e.g. CANADIAN MUTUAL FUND REPORT; and see generally, Williamson, *Capital Markets*; Williamson, *Financial Institutions*.

4 See paragraph 1.02(a).

capital to the persons who will use it most efficiently. The indirect effects of such conduct are, of course, to encourage industrial development and economic growth with a view to increasing employment and improving the functioning of the Canadian economy as a whole.

The section first places the securities market in its broader context⁵ and then indicates the more specific manner in which it contributes to the economy. In brief, the functions of securities markets are to facilitate the acquisition of capital from investors and to enable investors subsequently to dispose of their investments.⁶ Although the volume of securities traded on the secondary markets is substantially greater than that on the new issues market, economists generally state that the most important function of the securities market is that performed by the latter, namely, the allocation of funds to those who utilize them; for the allocational efficiency of the securities market affects the productivity of industry, employment and income and thus the overall growth of the economy. The secondary markets in debt and equity securities, that is, the over-the-counter market and the stock exchanges, respectively,⁷ in their turn control the availability and cost of new capital by providing a liquid market. That these functions are important in Canada today is emphasized by the projections of the Investment Dealers Association of Canada and others of capital needs over the rest of this century.⁸ The importance of investor confidence to the Canadian market's ability to meet such needs is highlighted by its inclusion in the final paragraph of the section.⁹

The policy enunciated in section 1.02 is not limited to the broad economic function of the securities market but extends as well to the so-called microeconomic level and deals with the actual functioning of the Canadian market. Thus it adverts to developments in computer technology and to their potential use in the market to create a truly national mechanism for securities trading.¹⁰ This process is already well under way as is indicated by the fact that the three major Canadian stock exchanges have a

5 See paragraph (a).

6 See generally, Williamson, *Capital Markets*, ch. II; W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* (1964); Friend, *The SEC and the Economic Performance of Securities Markets*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 185 (H. Manne, ed. 1969).

7 See generally, Williamson, *Financial Institutions*, ch. II.3.A-B.

8 See e.g. Williamson, *Capital Markets*, ch. I; A. Kniewasser, Address to the Association of Canadian Advertisers Incorporated, Toronto, May 1, 1978; and see REPORT OF THE ROYAL COMMISSION ON CORPORATE CONCENTRATION, ch. 11 (1978); cf. paragraphs (b), (c).

9 See paragraph (f), see also e.g. Howard at nn. 37, 60 and following.

10 See paragraph (d).

common system for simultaneously reporting trades on each of their floors, by the progress of the clearing mechanism run by the Canadian Depository for Securities, and by the development of computerized trading exemplified in Canada by the Toronto Stock Exchange's computer-assisted trading system (CATS).¹¹

That such a market will be beneficial and that Canada-wide standards are necessary to ensure its proper functioning and fair competition between market actors, whether they be securities firms, securities exchanges or other self-regulatory organizations, has been demonstrated by the experience in the United States relating to fixed commission rates and especially to the New York Stock Exchange's attempt to maintain its monopoly position by limiting membership and restricting off-board trades by its members, both before and since the enactment of the Securities Reform Act of 1975.¹² The experience during the last decade with arbitrage trading between the Montreal and Toronto stock exchanges and with uniform stock exchange commission rates indicates that the principles enunciated in paragraph (e) are at least equally necessary in Canada.¹³ Indeed, where alteration of the exchanges' commission rate schedule is contemplated, the exchanges have tended to reach agreement among themselves before applying to any of the provincial commissions for approval, and refusal by any commission to accept a new rate schedule has, in effect, resulted in further negotiations among the exchanges and the development of a more acceptable proposal. Similar matters of policy arise in relation to the ability of foreign brokers and dealers to enter Canada in order to carry on business.¹⁴

The question of foreign market actors reflects only one element of the increasing internationalization of securities markets. Automation is likely not only to lead to a Canada-wide securities market system in Canada but also to a national system in the United States. In fact one major purpose of the 1975 amendments to the Securities Exchange Act of 1934 was to require the Securities and Exchange Commission to develop such a market system through its supervisory powers over the exchanges and through rule-making. These parallel developments in Canada and the United States will inevitably lead to links between the two markets, facilitated by the computer technology and clearing

11 See generally, *Cleland; Jenkins; and see, Williamson, Capital Markets*, ch. IV; *Howard* at n. 76 and following; *Anisman & Hogg*, ch. II.3.

12 See *Howard* following n. 50.

13 See e.g. *Williamson, Financial Institutions*, chs. II.2.B, II.8, III.

14 See e.g. *id.* ch. II.6; *Connelly*, ch. V.B.; see also *Reynolds Securities (Canada) Ltd.*, 9 QSC Bull., No. 9 (Decision 5460, March 10, 1978) (requiring approval by Montreal

mechanisms that already exist. And it is likely that closer connections with European and Japanese markets will also be feasible in the near future. In short, the international aspects of securities regulation cannot in the last quarter of this century be ignored.¹⁵

This fact is now abundantly clear in connection with matters of enforcement under the present securities laws. Securities frauds and other schemes are not only conducted on a transprovincial basis that makes enforcement of provincial laws difficult, they are conducted on an international basis. That detection and remedial techniques for such operations necessitate international cooperation is amply demonstrated by the experience with Investors Overseas Services Ltd. (I.O.S. Ltd.) for which the establishment of an intergovernmental committee with representatives from five countries and two Canadian provinces was required.¹⁶

Section 1.02 follows the pattern of similar clauses in other federal legislation establishing the general policy goals of the statute. It may be used as a guide to the statute's interpretation¹⁷ and may also serve to highlight and perhaps bolster the constitutional basis for the enactment of the Draft Act by Parliament.¹⁸

Section 1.02 concludes, therefore, with a declaration of the purpose of the Draft Act, namely, that the ends enunciated in the preceding paragraphs will be promoted if material information is disseminated on a timely basis in markets which operate fairly and competitively and in which investors are protected from deceptive conduct. These goals can best be accomplished through an independent public authority responsible for the regulation of the Canadian securities market in cooperation with other Canadian and foreign government agencies. The fact that cooperation among the provincial commissions alone, although admirably furthered in the past decade and useful in areas such as prospectus clearance, is inadequate to the task was demonstrated in the development and approval by the British Columbia, Ontario and Quebec commissions of so-called "stock exchange takeover bids"¹⁹ and more recently by the events relating to the competing takeover bids for Husky Oil Limited. The purpose clause makes

Exchange of change of ownership); *In re Reynolds Securities (Canada) Ltd.*, [1978] OSC Bull. 101 (March) (denying application to approve change of ownership).

15 See generally, *Hebenton & Gibson*.

16 See paragraph (f).

17 See e.g. *R. v. Laserich*, 4 Alta. R. 148, 152-55 (N.W.T.C.A. 1977); and see Interpretation Act, s. 11; see also RENTON REPORT, ¶ 11.8.

18 Cf. Reference concerning the Validity of the Anti-Inflation Act, [1976] 2 S.C.R. 373, 422; and see generally, *Anisman & Hogg*.

19 See e.g. *In re Bralorne Resources Limited*, [1976] OSC Bull. 258 (September); Notice: Stock Exchange Take-Over Bids, [1976] OSC Bull. 325 (December).

clear, however, that it is not expected that a single national body can act unilaterally. Rather a nationally coordinated system of regulation that involves cooperation between a federal commission with federal jurisdiction and provincial and foreign commissions is necessary. Only such a scheme will permit the establishment on a Canada-wide basis of the minimum standards necessary to ensure investor confidence in the Canadian securities market.

Part 2

Definitions

Definitions in a statute may serve a number of functions. Most importantly, they specify the meaning of key words in order to make the act clearer and more easily understandable. They may also facilitate both comprehension and drafting by condensing into a single word a concept or group of words that would otherwise lead to unnecessary repetition and verbosity.¹ Part 2 contains examples of both types of definition but includes for the most part only terms that apply generally throughout the Draft Act. Definitions that are applicable to a single part or section are usually included in the part or the section itself and can readily be discerned from the table of contents.²

Several of the central concepts of the Draft Act are included in this Part in definitional form. The approach taken is to define them broadly and to limit their scope where necessary in relation to the application of the parts of the Draft Act that deal with substance.³ An attempt has thus been made to avoid the imposition of substantive requirements through the definitions. Nevertheless, in some instances, because of its applicability to several

1 *See generally* E. DRIEDGER, *THE COMPOSITION OF LEGISLATION* 45–48 (2d rev. ed. 1976); RENTON REPORT, ¶ 11.15.

2 *See e.g.* sections 7.04, 7.11, 10.01 and 13.01; *cf.* RENTON REPORT, ¶ 11.17.

3 *See, for example* the definitions of “person” and “security”, sections 2.29, 2.45, and Commentary.

parts of the Draft Act, a defined term may contain elements that have substantive ramifications.⁴

Section 2.01: “Advertisement”

Advertising is now so integral a part of marketing that virtually any sales effort directed at the public involves the use of newspaper or magazine advertisements or radio or television commercials. Not surprisingly, similar techniques are used in relation to trading in securities, most dramatically perhaps in advertisements announcing a takeover bid and most gently in television commercials recommending the purchase of the shares of a particular mutual fund. Indeed trades involving a selling effort, whether it be the promotion of a new issue of securities or a takeover bid, are most likely to provide a focus for the use of advertisements to induce investors to trade in securities. As a result, the Commission is empowered to regulate the use and content of advertisements in connection with a distribution and the exemptions from the disclosure requirements applicable to a distribution, that is, from the prospectus requirements, are generally conditional on there not being a sales effort or any advertising in connection with the sale.⁵ Similarly the Commission may require a registrant to submit for its scrutiny advertisements used in connection with any trading.⁶

The definition of “advertisement”, therefore, embraces all communications directed to the public to induce trading in securities. It is limited to communications that are publicly disseminated as only such communications require active regulation by the Commission. Representations made in direct negotiations are left to the general remedial provisions in parts 12 and 13.

Section 2.02: “Adviser”, “Broker”, “Dealer”, “Underwriter”, “Salesman” and “Securities Firm”

Part 8 of the Draft Act requires securities professionals to obtain registration and authorizes the Commission to establish standards for their conduct. As registration is required only of persons who carry on a securities business, the various classes of securities professionals are defined in functional terms, that is, in terms of the services performed by them. Thus an “adviser” is a person who furnishes advice to others (section 2.02), a “broker”

4 See e.g. section 2.22 and Commentary (“material fact”).

5 See sections 5.03, 5.13; and see generally part 6.

6 See section 11.10.

trades for others (section 2.07), a “dealer” trades for his own account (section 2.14), an “underwriter” distributes securities (section 2.49) and a “salesman” is defined simply as an employee who trades in securities for a broker or dealer (section 2.41). (The definition of “underwriter” is discussed in more detail below.⁷) Although the Ontario Securities Act, s. 1(1)5, defines “dealer” to include a broker, the regulations distinguish between the two functions, as does the Draft Act.⁸ The Commission is also authorized to classify securities professionals into subcategories in order to fashion regulations appropriate for each of them.⁹

As “adviser” is defined as a person who advises as to the value of securities and thus includes a person who processes and disseminates information relating to securities,¹⁰ it is expected that the Commission will exercise its powers of classification to provide appropriate registration requirements under part 8 for any such “advisers” who are not associated with a registered self-regulatory organization. And the processing and dissemination of information concerning securities trading by self-regulatory organizations such as securities exchanges or clearing agencies will be regulated pursuant to part 9.

In order to facilitate drafting, the Draft Act also contains a hybrid definition which incorporates all persons carrying on a securities business and which makes clear that a person may carry on a business which includes any or all of the functions contained in the defined categories.¹¹

Section 2.03: “Affiliate”, “Subsidiary” and “Control”

Affiliation of issuers is based upon the concept of “control”; thus a subsidiary and its holding issuer are affiliates, a subsidiary being an issuer controlled by another issuer (section 2.47). An issuer is also affiliated with all other subsidiaries of its holding issuer and with any other issuers controlled by the same person who controls it. It is not necessary to refer expressly to subsidiaries of the same issuer because such subsidiaries are by definition controlled by the same person.¹²

Because parent-subsidiary relationships and affiliation indicate common control within a group of issuers, affiliation provides the basis for a number of legal obligations under the Draft Act

7 See section 2.49, Commentary.

8 See Ontario Securities Regulations, s. 2(1).

9 See section 15.14; cf. *Connelly*, ch. III.A.

10 See ALI FEDERAL SECURITIES CODE, s. 299.52 (“securities information processor”).

11 See section 2.43 (“securities firm”).

12 See section 2.47 (“subsidiary”).

such as the filing of insider reports.¹³ Similarly the holdings of an offeror's affiliates are counted under paragraph 7.19(f) in order to calculate the percentage of securities necessary to constitute a takeover bid, and the potential impact of manipulative trading in a security on the securities of both the issuer and its affiliates is recognized in the anti-fraud provisions.¹⁴ Finally, the affiliation concept also provides a basis for the application of a number of accounting conventions such as consolidation of financial statements.

Because of the consequences flowing from affiliation, control continues to be defined in terms of legal rather than actual control.¹⁵ Some consideration was given to adopting a definition based on actual control, as is done in the *ALI Federal Securities Code*, s. 230,¹⁶ but this solution was rejected, at least on an act-wide basis. Where a different definition of "control" is required, the term is separately defined for purposes of the particular provision.¹⁷

Although the Ontario source provisions expressly include "two or more companies" in the definitions of "control" and "subsidiary", it is unnecessary to do so in the Draft Act because "person" includes an organized group of persons,¹⁸ and, in any event, because the Interpretation Act, s. 26(7), provides that the singular includes the plural. As a result an issuer may be controlled by a number of persons who together hold sufficient equity securities to come within the definition and may thus be a subsidiary of all such persons.

Section 2.04: "Associate"

The concept of an "associate" was added to Canadian securities legislation in 1966 in order to extend liability for insider trading, without imposing a duty to report their trades, to persons whose relationship to directors and officers of an issuer is sufficiently close that they are likely to have access to confidential information.¹⁹ As a result, some elements of the definition were criticized as being unduly restrictive.²⁰

13 See part 7C; and see e.g. *Anisman* at 188–89.

14 See e.g. section 12.07 (manipulation by trading).

15 See section 2.12.

16 Cf. *In re Steadman Security Corporation*, [1977–1978 Transfer Binders] CCH FED. SEC. L. REP. ¶ 81,243 at 88,339–18 n. 81 (SEC 1977).

17 See e.g. section 13.17(3).

18 See section 2.29 and Commentary; cf. e.g. Ontario Securities Act, 1978, ss. 1(3)–(4).

19 See KIMBER REPORT, ¶ 2.12; J. WILLIAMSON, SUPP. at 360–61.

20 See e.g. P. ANISMAN at 119–20 n. 293, arguing that the limitation (in paragraph (b))

However, in the Draft Act “associate” is not used to extend liability for insider trading. Rather, it is used to extend the reporting requirements of insiders to include trading by persons whose relationship with an insider is such that he may trade through them without reporting his trades.²¹ The concept of “associate” is also used to determine independent securityholders (section 4.01) and securities held by associates are counted toward the threshold percentage of securities necessary to constitute a takeover bid (paragraph 7.19(f)). Consequently, as with affiliation, the need to determine an “association” with certainty takes on added importance and is reflected in the definition, for example, in the retention of the limitation in paragraph (b).

It is perhaps worth mentioning that paragraph (a) is phrased in terms of *entitlement* to votes attached to outstanding equity securities in order to ensure that securities with multiple voting rights are given their full weight and also to make clear that rights to acquire voting securities are included in the determination of the percentage.²²

Section 2.05: “Association of Securities Firms”

The Draft Act contemplates the continuation of the present system of self-regulation in the securities market but formalizes it by requiring registration of all self-regulatory organizations and by specifying standards for the conduct of their self-regulatory activities in relation both to their members and to nonmembers.²³ Associations of securities firms are the first type of self-regulatory organization defined in the Draft Act. (The other two are clearing agencies and securities exchanges.²⁴) The definition limits “associations of securities firms” to those that perform some regulatory function in the securities market, that is, to those that may exercise regulatory powers delegated by a legislative body or by the Commission under section 9.05. It is clear therefore that only associations exercising public functions are required to register under part 9. Organizations of securities firms that do not exercise regulatory powers, such as trade associations or associations organized primarily to further their members’ interests by lobbying, are not subject to the Draft Act’s provisions.

to partners acting on behalf of a partnership is counterproductive in relation to liability for misuse of confidential information.

21 See paragraph 7.11(2)(e).

22 See section 2.18 (“equity security”).

23 See part 9.

24 See sections 2.10, 2.42 and Commentary; and see section 2.46 (“self-regulatory organization”).

Section 2.06: “Beneficial Ownership”

Beneficial ownership is defined in order to make clear for purposes of the whole of the Draft Act that the phrase is not limited to the common law concept of an equitable interest, but rather that it encompasses ownership of a security through all types of intermediary, whether they be trustees or merely agents. It thus facilitates a number of provisions intended to ensure that the true owner of a security is protected even though the security itself is held by a nominee or in street form.²⁵

The concept of beneficial ownership is extended for purposes of insider reporting in that an issuer is declared to beneficially own securities beneficially owned by its affiliates but as the extension is applicable only to the one context, the provisions are included in part 7.²⁶

Section 2.08: “By-laws” and “Regulations”

The Draft Act contemplates subordinate legislation by the Commission and the self-regulatory organizations. The Commission may make rules, on occasion subject to ministerial approval, relating to its internal business and may make regulations, always subject to approval by the Cabinet (the Governor in Council), implementing the substantive policies authorized by the Draft Act.²⁷ Similarly all by-laws made by a self-regulatory organization are subject to Commission approval under part 9 and procedures for the adoption of regulations and for judicial review of those adopted are provided as well.²⁸ For purposes of judicial review, it should be stressed that “regulation” as defined in section 2.37 includes rules made by the Commission.

The terminological distinction between “regulations” and “by-laws” was adopted in order to facilitate both the drafting and the interpretation of the Draft Act. This approach, as well as the use of “rules” and “regulations” to distinguish internal rules from substantive regulations, is in general accord with that in other federal statutes. The definition of “regulation” includes both by-laws and regulations under this act but not policy statements issued by the Commission and not orders of the Commission which are adjudicative and not legislative decisions.²⁹

25 See e.g. part 10 (clearing agencies) and section 7.09 (voting by nominees).

26 See subsection 7.11(2).

27 See sections 15.13 (rules), 15.14 (regulations).

28 See sections 15.15, 15.20.

29 See section 2.27 and Commentary; cf. e.g. *National Labor Relations Board v. Wyman-Gordon Company*, 89 S. Ct. 1426 (U.S.S.C. 1969).

Section 2.09: “Calls” and “Puts”

The definitions of “call” and “put” derive from the Canada Business Corporations Act in which they are used only in relation to trading by insiders.³⁰ Subsection 124(2) of that act prohibits insiders from buying puts or calls on shares of their corporation. The primary use of the terms in the Draft Act is for the same purpose.³¹ The second clause of the definition of “call” is included to ensure that an issuer may grant options to its officers and other employees as compensation for their services and may issue rights to acquire its securities to any of its insiders. As an issuer may grant an option to purchase securities of one of its affiliates as compensation to employees, such options should also be excluded from the definition and the section does so in the belief that this extension of the source provision will not create a gap in the coverage of subsection 12.03(2).

The terms may also be used in the administration of the Draft Act, for example, in relation to trading in puts and calls on an “options exchange”. In fact, one such exchange now operates in Canada.³²

Section 2.10: “Clearing Agency”

Clearing agencies are the second type of self-regulatory organization defined in the Draft Act.³³ As with similar provisions, “clearing agency” is defined in functional terms to include an organization that provides facilities for and handles the settlement among brokers and dealers of their securities trades as well as one that acts as a custodian for securities certificates and maintains records of securities transfers as part of a book entry system that enables the transfer of securities without physical delivery of certificates. Both types of clearing agency are now operative in Canada. The former are generally owned and operated by a securities exchange, for example, the Vancouver Stock Exchange Service Corporation which handles the clearing and settlement of transactions on the Vancouver and Alberta exchanges; the latter type may be so owned or may be independently organized like the Canadian Depository for Securities Ltd., whose founding members include the Toronto and Montreal exchanges and a number of financial institutions.³⁴ All organiza-

30 See also section 2.33.

31 See section 12.03(2).

32 See, *Williamson, Capital Markets*, ch. II.8.A.

33 See also sections 2.05, 2.42 and Commentary.

34 See generally part 10, Commentary.

tions falling within the definition are required to register as self-regulatory organizations under part 9 and it is expected that the Commission will establish procedures and standards for registration that enable an exchange and its clearinghouse, where appropriate, to combine their registrations.

The self-regulatory aspects of clearing agencies are thus dealt with under part 9. However, as a substantial amount of clearing and settlement of securities transactions in Canada is now handled by the Canadian Depository for Securities and as it is likely that the use of such systems will increase, part 10 of the Draft Act provides a regime to authorize and facilitate a book entry system for securities transfers. (It is worth noting in this context that pledges of securities in such a system constitute transfers.³⁵)

The definition of "clearing agency", like those of other self-regulatory agencies, is directed only at organizations performing essentially public functions in the securities market.³⁶ Securities firms and financial institutions such as banks and insurance, loan and trust corporations that are likely to engage in similar conduct for their clients or for their own accounts are therefore excluded from the definition so long as their activities are confined to their customary business. And the Commission is given the power to limit their exclusion by regulation if circumstances arise in which such activities have the effect of undermining the functioning of a registered agency.

Section 2.15: "Deception"

"Deception" is defined to include all conduct that is likely to result in a person being deceived or misled whether it consists of a failure to fulfill a duty to disclose material information or to act or of positive conduct as specified in paragraph (b). The definition thus encompasses not only fraudulent conduct prohibited by the Criminal Code and by the extended definition of "fraud" in some provincial securities acts³⁷ but also the common law concept of civil fraud, including equitable fraud where no fiduciary obligation exists.³⁸ Although paragraph (b) is broad enough to include a misrepresentation, the Draft Act contains a separate definition of "misrepresentation" in section 2.24 in order to avoid confusion, and both terms are used in the substantive provisions.

35 See paragraph (c) and section 10.07.

36 Cf. section 2.05 and Commentary.

37 See e.g. Newfoundland Securities Act, s. 2(c).

38 See e.g. *Kaas v. Privette*, 529 F.2d 23, 27 (Wash. App. 1974) (dictum); cf. *Gronan v. Schlamp Investments Ltd.*, 52 D.L.R. (3d) 631 (Man. Q.B. 1974).

Although the elements of the definition of “deception” derive from the British Columbia Trade Practices Act and the *ALI Federal Securities Code*, they are not in substance dissimilar to the conduct defined as fraud by the Law Reform Commission of Canada in a recent working paper.³⁹ However, as the Law Reform Commission’s working paper deals only with the criminal law, its definition requires “dishonesty”, unlike the definition of “deception” which contains, in criminal law terminology, only the *actus reus* for fraud. In other words, the elements of the definition are merely descriptive of the conduct specified. The mental elements necessary for liability, whether civil or criminal, and the requisite connection with securities trading are left to the provisions of the Draft Act that create liability.

Even though it is used in only one substantive provision, “deception” is included in the general definition Part of the Draft Act because it establishes the basis for the residual prohibition against misleading securities schemes and is therefore central to the act. In brief, the scheme of the act is as follows. Deceptive conduct is defined objectively in section 2.15 and prohibited in connection with transactions involving securities by section 12.01. A criminal conviction may be obtained only for a knowing or reckless violation, that is, where the usual *mens rea* for fraud is proved.⁴⁰ The Draft Act does not expressly create civil liability for a violation of section 12.01 but instead authorizes the courts to impose such liability on the basis of the standard most appropriate to the conduct involved in light of the remedies that are expressly contained in part 13. As a result civil liability may flow from negligent, reckless or intentional deception but the burden of convincing a court of both the standard for and the justice of imposing liability lies on the plaintiff.⁴¹ The only substantive provisions that permit action for deception that is neither intentional nor negligent are sections 14.01 and 14.06 which authorize the Commission to initiate an investigation and to apply to a court for an injunction so that it may prevent the continuation of conduct that has the effect of misleading investors. In the latter case the usual standards for injunctive remedies apply.⁴²

The scheme is potentially broader than the recent interpretations of the federal securities laws in the United States in that

39 See LAW REFORM COMMISSION OF CANADA, CRIMINAL LAW: THEFT AND FRAUD 14-15, 32-36 (Working Paper 19, 1977) and especially proposed sections 5.1(b) and (c), 5.4 and 5.5 concerning “unfair non-disclosure” and “unfair exploitation”.

40 See section 14.10

41 See section 13.16 and Commentary.

42 See section 14.06, Commentary.

deception is not limited to fraud or to intentional conduct.⁴³ Rather, as stated above, it includes conduct that has a misleading effect whether or not it is intentional or reckless.⁴⁴ As a result it is also broader than the solution adopted by Professor Loss in that it contemplates the possibility of civil liability for negligently deceptive conduct.⁴⁵ In light of the general reluctance of Canadian courts in the past to imply a cause of action from the violation of a regulatory statute, the availability of such actions under the Draft Act creates little danger of unjustified liability.⁴⁶

Section 2.16: “Director”

The definition of “director” follows the *ALI Code* more closely than the Canadian source provisions, primarily because it contains the dual standard for determining whether a person is a “director” of a corporation or an unincorporated organization. The *ALI Code*, however, expressly excludes a person who deputizes another to act as a director; the provision is necessary in order to avoid the “deputization theory” that has been adopted in the United States for purposes of insider liability for short swing trading.⁴⁷ The possibility of such a theory being adopted under the Draft Act is precluded by defining a director as a “natural person”. The analogous problem of imputing knowledge to an organization is dealt with in the context of insider trading.⁴⁸

Section 2.17: “Distribution”

The sale of new issues of securities to public investors has long provided a major focus, for many years the primary one, for disclosure by issuers, usually in the form of a prospectus filed with a public body and circulated to purchasers.⁴⁹ The prospectus requirements in securities laws have traditionally been activated by

43 See e.g. *Ernst and Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Carroll v. First National Bank of Lincolnwood*, 413 F. 2d 353 (7th Cir. 1969), *cert. denied* 396 U.S. 1003 (bank participating in manipulative scheme by purchasing securities on payment-on-delivery basis); cf. also *Walton v. Landstock Investments Ltd.*, 72 D.L.R. (3d) 195, 198 (Ont. C.A. 1976) (misrepresentation by conduct).

44 Cf. *Findlay v. Couldwell*, 69 D.L.R. (3d) 320 (B.C.S.C. 1976); *Director of Trade Practices v. Household Finance Corporation of Canada*, [1976] 3 W.W.R. 731 (B.C.S.C.), *affirmed* [1977] 3 W.W.R. 390 (B.C.C.A.) (interpreting the British Columbia Trade Practices Act).

45 Cf. ALI FEDERAL SECURITIES CODE, s. 262, Note (2).

46 See e.g. *Leigh* at n. 117 and following.

47 See Securities Exchange Act of 1934, s. 16(b); and see e.g. *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied* 396 U.S. 1036 (1970).

48 See section 12.03, Commentary.

49 See e.g. *Grover & Baillie*, ch. II.

a distribution or offering made to the "public".⁵⁰ However, because of difficulties with the concept of "the public", recent proposals in Canada and elsewhere have recommended that prospectus disclosure not be dependent upon it.⁵¹ Instead they recommend a comprehensive system requiring disclosure in relation to all distributions that are not expressly exempted.⁵² Nevertheless, the underlying policy remains; the proposed legislation merely attempts to ensure that appropriate disclosure will be made when there is an "appeal for capital from outsiders" by an issuer,⁵³ or when a substantial number of securities, usually held by a controlling shareholder, requiring a major selling effort is sold to investors generally or when a public market in a security develops.

The definition of "distribution" is thus central to the scheme of prospectus disclosure in the Draft Act. A prospectus is required where a sale of securities constitutes a distribution and the exemptions from the prospectus provisions are, of course, necessary only in such circumstances.⁵⁴ The Draft Act, while following the trend of modern securities legislation reflected in the source provisions, attempts to simplify the scheme for prospectus disclosure without either diminishing investor protection or the ability of issuers and selling securityholders to determine their duties under it.

The Draft Act contemplates four types of "distribution". The first is relatively straightforward and follows the provincial models; any sale of a security by or for an issuer constitutes a distribution. The definition encompasses not only a traditional new issue of securities but also a resale of securities of the issuer "that have been redeemed or purchased by or donated to" it,⁵⁵ as is made clear by the concluding clause of paragraph (a). It is essential so that an issuer may not purchase and redistribute a class of preference shares or debt securities free of the Draft Act's requirements and also limits the possibility of an issuer attempting to make a market in its own securities. But a reporting issuer may avail itself of the trading transaction exemption in section 6.04.⁵⁶

Paragraph (b) of the definition ensures that the exemption granted by sections 6.01 and 6.02 may not be used for a two step distribution or to create a public market in a security without

50 See e.g. Ontario Securities Act, s. 1(1)6a; and see J. WILLIAMSON, SUPP. at 120-23; D. JOHNSTON at 148-55.

51 See, *Grover & Baillie* at nn. 249-54.

52 See e.g. Ontario Securities Act, 1978, s. 1(1)11; ALI FEDERAL SECURITIES CODE, s. 242.

53 *Grover & Baillie* following n. 247.

54 See generally parts 5, 6.

55 Ontario Securities Act, 1978, s. 1(1)11(ii).

56 See section 6.04 and Commentary.

filing a prospectus⁵⁷ by including as a distribution the sale of a security by any person who has purchased it from an issuer or underwriter. The prevention of the above abuses does not, however, necessitate that all initial purchasers of securities be precluded indefinitely from trading their securities without filing a prospectus, especially where information adequate to permit investors to investigate the nature of their investment is publicly available, that is, where the issuer is a reporting issuer subject to the continuous disclosure requirements of the Draft Act.⁵⁸ The paragraph, therefore, excludes securities of reporting issuers where a purchaser has held them for at least six months or another period prescribed by the Commission by regulation. The holding period is required to prevent a two step distribution by an issuer or controlling securityholder and the Commission's power to make regulations permits it to extend the period where necessary to ensure that the issuer has been a reporting issuer for sufficient time to permit the information disclosed in its filings to be disseminated and for it to have developed a following. The power may be used as well to require that the reporting issuer not be in default of any reporting requirements.⁵⁹ In result the requirements of the Draft Act are substantially similar to those of the more recent source provisions but with a shorter holding period.⁶⁰ And in appropriate circumstances the Commission may shorten the period further.

It is worth reiterating that any person whose trading constitutes a "distribution" may avail himself of the exemptions in part 6. Thus, public investors trading on their own behalf may use the exemption in paragraph 6.01(h) or section 6.04 even within the six-month period and securityholders of non-reporting issuers may trade on the basis of the former exemption. And if the issuer is "private", all trading in its securities is exempt.⁶¹ Finally, if experience demonstrates that the definition includes non-exempt trading for which prospectus disclosure is inappropriate, the Commission may create further exemptions under section 3.03.

Paragraphs (c) and (d) are directed at distributions on behalf of persons other than an issuer. The former provision includes traditional secondary distributions by controlling shareholders whose ability to control the issuer enables them to obtain the information to prepare a prospectus and to time their distribution

57 See e.g. *Great Sweet Grass Oils Limited*, 37 SEC 683 (1957).

58 See parts 4, 7 and Commentary.

59 Cf. e.g. Ontario Securities Act, 1978, ss. 71(4), (5), (7); *Rulings Pursuant to Section 56*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, May 13, 1977, at 1 (amendment to local Policy Statement No. 3-14).

60 See, *Grover & Baillie* at nn. 287-92 and 376-91.

61 See paragraph 3.01(e); and see, *Grover & Baillie* following n. 377.

appropriately. The present Canadian provisions define secondary distributors in terms of whether their holdings of securities “materially affect control” of the issuer; paragraph (c) alters the standard to reflect its substance, the seller’s ability to influence the management and policies of the issuer, in order to avoid a potentially restrictive reading as a result of the definition of “control” in section 2.12.

The rationale for including sales by non-controlling shareholders as distributions is based upon the fact that their holdings are sufficiently large that their sale will affect substantially the market price of the security so that some sort of sales effort and market grooming are required. It is expected that the Commission will specify figures based upon the selling effort required for the sale and the impact on the market that is likely to result from it and that in doing so it will utilize its experience with the trading transaction exemption in section 6.04 so that the definition and the exemption complement each other. Presumably most sales by financial institutions and other sophisticated investors will come within the exemption. In any event the disclosure requirements for such distributions are expected to be substantially less onerous than for others.⁶²

Although Grover and Baillie recommend that large sales by substantial investors be treated as distributions,⁶³ they also state some reservations about the potential impact of such a provision on the willingness of institutional investors to purchase securities and suggest that it should not be enacted unless it is clear that “no significant negative results” will follow.⁶⁴ Paragraph (d) and the statutory consequences that follow from it are included, therefore, as a means of focusing attention on the potential implementation of the recommendation to invite discussion and thus obtain a more accurate evaluation of its likely consequences.⁶⁵

Section 2.18: “Equity Security”

As many of the provisions of the Draft Act apply only to securities that entitle their holders to vote at meetings of the issuer, a definition of equity security is essential.⁶⁶ The definition derives primarily from the Canadian source provisions and has

62 See section 5.04 and Commentary.

63 See, *Grover & Baillie* at n. 409.

64 *Id.* following n. 342; and see *id.* ch. VI.3.

65 See especially the treatment of “block distribution circulars” in part 5 and Commentary; and see subsection 13.09(3) and Commentary.

66 See e.g. section 4.01.

been modified in light of the new definition of a “right to acquire” included in section 2.39.

The *ALI Code* defines an “equity security” as a “share...or similar security” and contains a separate definition of “voting security” based upon current entitlement of holders to vote for the election of directors.⁶⁷ The Draft Act is extended to include rights to acquire a voting security in order to include persons who may have an effective voice in an issuer’s affairs because of their ability to obtain voting securities, especially as the primary use of the concept relates to insider reporting and takeover bids.⁶⁸ Calls are excluded from the definition because they are issued by a person other than the issuer of the underlying security.⁶⁹

Sections 2.19 and 2.20: “Expert” and “Filing”

The definitions of both “expert” and “filing” are included primarily to facilitate drafting. The concept of expertise appears frequently in the Draft Act, especially in relation to the contents of disclosure documents, and the definition removes the need to repeat its content in each instance.⁷⁰ The latter definition similarly makes clear a term that is frequently used. Although filings are generally available to the public, the Commission may by regulation provide that documents submitted to it on a confidential basis shall not be made public.⁷¹

Section 2.21: “Issuer”

The Draft Act includes a definition of “issuer” to make clear that it encompasses all persons who have issued, are issuing, or propose to issue securities. The breadth of the definition is reinforced by the equally broad definition of “person” which includes natural persons, corporations and any type of organization whatever⁷² and is necessary because of the Draft Act’s emphasis on continuous disclosure.⁷³

67 See ALI FEDERAL SECURITIES CODE, s. 299.82(a)(1); cf. Ontario Securities Act, 1978, s. 1(1)44.

68 See sections 7.11, 7.19.

69 See section 2.09; cf. ALI FEDERAL SECURITIES CODE, s. 248, Note.

70 See e.g. paragraph 8.06(4)(b) and sections 13.05, 13.06.

71 See section 16.08.

72 See section 2.29.

73 See parts 4, 5, 7.

Section 2.22: “Material Fact”

The definition of a “material fact” is essentially the meaning of the term at common law.⁷⁴ The same meaning has generally been attributed to materiality under securities legislation, especially in relation to statements in documents sent to shareholders such as a prospectus or proxy circular,⁷⁵ and has been used in the context of insider trading.⁷⁶

Another formulation of the standard of materiality has also been used by the courts in relation to insider trading.⁷⁷ The latter standard has been adopted in the Ontario Securities Act, 1978. Although the act distinguishes between materiality in relation to the affairs of an issuer and materiality in relation to its securities, it defines both “material change” and “material fact” as events that “would reasonably be expected to have a significant effect on the market price or value of” a security.⁷⁸ It is arguable that for purposes of insider trading there is no difference between the two formulations⁷⁹ but in other contexts the definition in the new Ontario act may impose a stricter standard of materiality. For example, because “misrepresentation” is defined in terms of “material facts”,⁸⁰ an untrue statement in a prospectus that would not significantly affect the price or value of the security being issued but that would influence a reasonable investor in deciding whether to purchase the security would not constitute a “misrepresentation”; as a result, a purchaser could not avail himself of the rescission remedies provided in the act. While the former standard may be appropriate for insider trading and continuous disclosure by issuers, it may not be so in the context of new issues. Indeed, Professor Loss has concluded that the “stricter” standard is applicable in the context of insider trading and has created a separate definition limited to insider trading that is essentially the same as the one in the Ontario act.⁸¹ To avoid confusing the standards applicable to the concept, the Draft Act adopts for general purposes the common law definition of materiality and incorporates it

74 See e.g. *Piggott v. Nesbitt Thomson & Co. Ltd.*, [1939] O.R. 66, 76 (C.A.), *affirmed*, [1941] S.C.R. 520.

75 See e.g. *T.S.C. Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) R. v. Kott, 8 QSC Bull., No. 2, January 18, 1977, at 4–5 (Que. C.S.P. June 8, 1976).

76 See, *Anisman* at 231–33; cf. *Alton Box Board Co. v. Goldman Sachs and Company*, [1977–1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 96,127 at 92,068 (8th Cir. 1977) (same test of materiality in all circumstances).

77 See e.g. *Yontef*, ch. III.C.6.

78 *Id.* ss. 1(1)21, 22.

79 See e.g. *Anisman* at 232.

80 Ontario Securities Act, 1978, s. 1(1)24.

81 See ALI FEDERAL SECURITIES CODE, s. 257 (“fact of special significance”); see also *id.* s. 293 (“material”).

in the prohibition against insider trading in section 12.02. The adverbial phrase requiring that it be applied in the circumstances relevant to the decision in question makes the definition readily adaptable to all of the contexts in which it is used.⁸²

Subsections (2) to (4) derive from the *ALI Code* which extends the provision in the *Restatement of Torts Second* relating to deceit to include cases in which a defendant can show that the plaintiff did not rely on an undisclosed material fact.⁸³ In effect, subsection (2) extends the scope of liability to include cases involving the misrepresentation or non-disclosure of a fact that, although not material, the person making it knows would influence the other party, subsection (3) provides a defence where a plaintiff does not rely on a fact even though it is material within the definition of subsection (1) and subsection (4) allocates the burden of proving that a variation from the basic definition is appropriate. Although subsections (3) and (4) contain substantive elements, they are included in the definition so that the defence in subsection (3) applies throughout the Draft Act and is available in both an action for civil liability and a criminal prosecution based upon a misstatement or material omission.

Section 2.24: “Misrepresentation”

The definition of “misrepresentation” incorporates provisions that have been included in all securities legislation, usually in the sections creating liability for misstatements, and reflects the common law position in relation to both rescission and damages. Ontario’s new act defines a misrepresentation simply as a false statement of a material fact or “an omission to state a material fact” and leaves the modification required by the circumstances to the provision creating an offence for misstatements. The definition in section 2.24 includes the “circumstantial” language in order to facilitate the drafting of the substantive provisions.⁸⁴

As with “deception”, no element of intent is contained in the definition of “misrepresentation”. Rather the requisite mental element and the connection with a securities transaction are specified in the provisions prescribing liability in parts 13 and 14.⁸⁵

82 See e.g. section 7.03 (press release of material fact); but see, *Yontef* following n. 248.

83 See ALI FEDERAL SECURITIES CODE, s. 293; Tent. Draft No. 2, s. 256(b), Comments (1), (2).

84 Cf. ALI FEDERAL SECURITIES CODE, s. 297(a).

85 See also section 2.15, Commentary; cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 259(a), Comment (3).

Section 2.25: “Mutual Fund”

The definition of “mutual fund” is a composite derived primarily from the two-pronged definition in the *Mutual Fund Proposals*.⁸⁶ It attempts to incorporate in a single provision the essential elements of this type of investment vehicle, namely, the right of shareholders to require redemption at any time and to receive the proportionate interest in the fund’s assets represented by the security⁸⁷ and is sufficiently comprehensive to include a separate fund or trust account or any similar arrangement. The definition is used in the exempting provisions.⁸⁸

Section 2.26: “Officer”

The definition of “officer” has been influenced by all of the source provisions. Paragraph (a) lists the offices included in the Canada Business Corporations Act; the paragraph is in substance the same as that in the *ALI Code* and the definition of “senior officer” in the provincial legislation. (The definition of “officer” in the provincial securities acts is slightly broader.)

Paragraph (b) extends the definition to include persons who act as officers whatever their office is called and paragraph (c) is a variation on the same theme in that the five highest paid employees are likely to participate fully and exercise influence on the major policy decisions of their organization whether or not they occupy or perform the usual duties associated with a specified office. The *ALI Code* attempts to achieve the same end by codifying the underlying standard so that “officer” includes any employee “who participates or has authority to participate, otherwise than as a director, in major policy-making functions”. This approach was not adopted in the Draft Act because of its breadth. The limitations of the Canadian source provisions provide greater certainty, which assumes importance in light of the use made of the term in the Draft Act.⁸⁹

All of the source provisions define officers in terms of issuers. Indeed, the provincial securities acts limit it to “companies” thus excluding unincorporated issuers.⁹⁰ The Draft Act defines officers in terms of their position with a “person” to make clear that the

86 See 2 MUTUAL FUND PROPOSALS, ss. 1.01(1) “mutual fund” and “mutual fund share”.

87 See 1 MUTUAL FUND PROPOSALS at 12.

88 See paragraph 3.02(1)(c) and Commentary.

89 See e.g. parts 7, 13.

90 See e.g. Ontario Securities Act, ss. 1(1)4, 11, 23; cf. Ontario Securities Act, 1978, s. 1(1)41 (“of an issuer”).

definition applies to all organizations, whether or not incorporated, including registrants and self-regulatory organizations.⁹¹

Section 2.27: “Order”

Quasi-legislative decisions of the Commission usually take the form of regulations and are subject to the procedures prescribed for regulations in part 15.⁹² The Commission’s adjudicative powers are exercisable by orders and the procedures for them are also specified in part 15.⁹³ In view of the potential breadth of the definition, regulations and policy statements are expressly excluded to make clear that a decision to adopt or publish either of them is not an “order”.

Whereas the by-laws of a self-regulatory organization are subject to Commission review and approval either when they are promulgated or at the initiation of the Commission itself, adjudicative decisions of a self-regulatory organization are reviewable only when they directly affect individual interests.⁹⁴ The definition of “order” includes the latter types of self-regulatory decisions but not the former as by-laws are a type of regulation.⁹⁵

“Order” is used as well in the Draft Act to mean an order made by a court and a particular type of trade in a security, such as an order to purchase or sell.⁹⁶ In all such cases it is clear from the context that the definition in section 2.27 does not apply.⁹⁷

Section 2.28: “Participant”

It is expected that only securities professionals and other regulated intermediaries will have direct access to a clearing agency and that public investors whose ownership is recorded in an agency’s books will participate through registrants. “Participants” are, therefore, limited to persons who receive services directly from a clearing agency on behalf of themselves or their clients, and the substantive provisions of the Draft Act ensure that no person who should be entitled to deal with an agency will be excluded from it.⁹⁸ Paragraphs (a) and (b) thus make clear that

91 Cf. *id.* s. 1(1)27 (“of an issuer or a registrant”).

92 See section 2.08, Commentary.

93 See sections 15.17, 15.18 (hearing procedure), 15.19 (judicial review). Such orders are, therefore, clearly not “statutory instruments” under the Statutory Instruments Act, S.C. 1970-71-72, c. 38, s. 2(1)(d)(iv).

94 See section 15.18.

95 See section 2.08.

96 See e.g. sections 12.06, 14.06.

97 Cf. Interpretation Act, s. 14(2)(a).

98 See sections 9.03, 9.09 (all registrants, regulated financial intermediaries and other persons specified by the Commission may become participants).

investors whose securities are “held” by an agency through their brokers are not “participants”.

It is worth mentioning that membership in a clearing agency is not synonymous with participation. The members of a clearing agency will likely be the persons who are responsible for its establishment and for enacting its by-laws and they may or may not themselves make use of its facilities. For example, the Investment Dealers Association of Canada is a member of the Canadian Depository for Securities but no securities need be held in its name or cleared for it by the depository.⁹⁹

Section 2.29: “Person”

The definition of “person” is sufficiently broad to cover individuals and organizations of any type including governmental organizations. Whether any of the groups included in the definition should or should not be subject to a particular Part or provision of the Draft Act is a question of substance and is dealt with as such in the Part itself.¹⁰⁰

A few rather technical comments may be appropriate. The definition includes natural persons and both corporations and unincorporated organizations. The “person-company” dichotomy in the provincial securities acts derives from constitutional considerations and has imposed awkward drafting requirements on the provincial acts.¹⁰¹ As the same considerations do not apply, the dichotomy is not necessary here. And, in any event, a comprehensive definition of “person” is preferable.

A syndicate is not expressly mentioned in the definition because it is included already as a “partnership, association...or other organized group of persons”. A “fund” is expressly included to make clear that a fund, even if only a separate account, may be treated as an entity where appropriate for purposes of the Draft Act.¹⁰²

Substantial difficulties have occurred in both the United States and the United Kingdom over the determination whether a group of persons acting in concert is itself a “person” subject to reporting or other requirements, especially in the context of insider reporting and takeover bids.¹⁰³ Indeed, the *ALI Code* includes a

99 Cf. section 2.10 (“clearing agency”).

100 See e.g. part 3.

101 See P. Anisman, *The Person-Company Dichotomy in the Ontario Securities Act: Its History and Development* (unpublished paper on file in Consumer and Corporate Affairs, Canada, 1967); J. WILLIAMSON at 25–26; J. WILLIAMSON, SUPP. at 2.

102 See e.g. section 9.13 (contingency fund).

103 See e.g. P. ANISMAN at 111 n. 268; *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971),

separate provision authorizing the Commission to define by rule a group of persons acting in concert “for the purpose of acquiring, holding, voting, or disposing of securities” as a “person”.¹⁰⁴ The Draft Act does not attempt to resolve this question in the definition. Instead “person” is defined broadly enough to include persons acting in concert pursuant to an agreement or understanding, whether formal or informal, for any of the above purposes and the matter is left for determination in particular cases by the Commission and the courts.¹⁰⁵

Paragraph (c) is necessary in order to include foreign governments that sell their securities in Canada.¹⁰⁶ It also includes the federal or a provincial government, for the presumption against the applicability of legislation to the Crown is expressly rebutted in section 16.15.¹⁰⁷ As a result government and municipal securities are subject to the Draft Act unless expressly exempted. The securities of Canadian political units are expressly exempted from the disclosure requirements by paragraph 3.02(1)(a) but remain subject to the anti-fraud provisions of parts 12, 13 and 14.

Section 2.31: “Public” Information

This section defines when information becomes public. The essential concept in the section is the time when facts cease to be confidential, but the definition is framed in positive terms because of the importance of the concept in relation to offences and civil liability. The prohibition against insider trading, for example, is limited to confidential information; and the concept is used throughout part 13 to define potential plaintiffs and to limit liability for misrepresentations.¹⁰⁸

Section 2.31 defines when information ceases to be confidential by establishing a general standard. It makes clear that the filing of a document or the mere issue of a press release by an issuer is not sufficient to make information “public”; rather, information remains confidential until sufficient time has passed for it to be generally disseminated to investors. The section thus imposes a “waiting period” but leaves the precise time required for determi-

cert. denied, 92 S. Ct. 1610 (1972); *Marc Gregory Ltd. (Panel on Take-overs and Mergers)*, July 24, 1973; and *see*, THE CITY CODE ON TAKE-OVERS AND MERGERS 9 (Rev. April 1976) (“Acting in Concert”).

104 ALI FEDERAL SECURITIES CODE, s. 299.24(a).

105 *See* paragraph (a) (“organized group of persons”).

106 *Cf. Pfizer, Inc. v. Government of India*, [1978–1] CCH TRADE CAS. ¶ 61,812 (U.S.S.C.).

107 *Cf. Interpretation Act*, s. 16; *Re PWA Airlines Ltd.*, 2 A.R. 539 (S.C.C. 1977) (*per* Laskin, C.J.C.).

108 *See e.g.* sections 12.02, 13.04.

nation in a particular set of circumstances, including the complexity of the information itself and the form of dissemination, or for further specification by the Commission in light of its experience under the Draft Act.

The time when information ceases to be "confidential" under the present Canadian insider liability provision is not clear.¹⁰⁹ The Ontario Securities Commission has stated that a one-day waiting period will usually be sufficient¹¹⁰ and the source provision specifies a period of one week unless the Commission alters it by rule.¹¹¹ However, the Draft Act does not adopt a fixed period. Any period specified is likely to require qualification in order to avoid undue rigidity and the desired certainty would not exist in any event. The Draft Act therefore adopts a reasonableness standard that is likely to be interpreted in light of the circumstances mentioned above and also permits the Commission to specify a fixed period if it thinks it appropriate. In fact, the Commission may prescribe different periods depending upon the nature of the information or the manner of its dissemination and thus refine the standard in ways that are not practicable in the statute.

In short, the definition is intended to ensure that actual dissemination occurs before confidential information becomes "public". It is not sufficient, for example, merely to issue a press release; the release must be such that it is likely to come to the attention of a reasonable investor *and* sufficient time must pass for it to do so. Thus an insider will not escape the prohibition in section 12.02 unless the press release has been carried in a newspaper or other public medium that fulfills the above requirements. If it has not, an insider "will simply have to desist from trading".¹¹² And the Commission will presumably consider these factors when prescribing specific time periods under the section.

Section 2.32: "Purchase", "Sale" and "Trade"

"Purchase" and "sale" are derived substantially from the Ontario source provisions. The definition of "sale" is essentially the initial subparagraph of the Ontario definition and a "purchase" is simply the converse of a sale.¹¹³

The Ontario Securities Act, 1978, s. 1(1)42(i), expressly

109 See e.g. *Anisman* at 229-31.

110 See, *In re* Harold P. Connor, [1976] OSC Bull. 149, 177 (June).

111 See ALI FEDERAL SECURITIES CODE, s. 265; see also Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STANFORD L. REV. 371, 394 (1974) (four days).

112 ALI FEDERAL SECURITIES CODE, s. 16.03, Comment (7)(c).

113 See section 2.40; cf. Ontario Securities Act, s. 1(1)24(i).

excludes purchases from the meaning of "trade", the term used in the act to define securities transactions, and the present Ontario act may also do so as a matter of interpretation.¹¹⁴ The one-sided definition in the new Ontario act may, however, lead to difficulties of application in relation to transactions involving a purchase, for example, a takeover bid made in violation of the act's provisions.¹¹⁵ In light of the definition of "trade" the remedial section is applicable to share exchange takeover bids but not to cash bids.

The Draft Act contains definitions of both "sale" and "purchase" and includes both sales and purchases in its definition of "trade".¹¹⁶ The former terms are used in provisions which are intended to apply to only one side of a transaction and the latter where a provision applies to all transactions that meet its requirements whether they are initiated as sales or purchases.¹¹⁷

The *ALI Code* defines offers to buy and sell as well as sales and purchases.¹¹⁸ The Draft Act covers the same ground by including the substance of such offers in the extended meaning of purchases and sales.¹¹⁹ As a result, a purchase includes a solicitation of an offer to sell, and a sale, a solicitation of an offer to purchase. And a sale also includes the initial issue of previously unissued securities and the exercise of a right to acquire a security.¹²⁰ The extended definitions of "purchase" and "sale" and therefore of "trade" are necessary to preclude unauthorized market grooming in connection with a distribution.¹²¹

Paragraph 2.48(c) ("trade") is a modified version of the equivalent paragraph in the Ontario source provisions¹²² altered so that it applies to transactions on the floor of an exchange and also to transactions through the automated exchanges of the future. Any persons who carry on business exclusively as floor traders or as professional traders who execute transactions in an automated market only for registrants are required to apply for registration under part 8 or to obtain an exemption from the Commission.

The Ontario source provisions include as a "trade" "any re-

114 Cf. *Prudential Trust Co. Ltd. v. Forseth*, [1960] S.C.R. 210, 225 (1959); but see *J. WILLIAMSON*, SUPP. at 116; *P. ANISMAN* at 28 n. 32.

115 See e.g. Ontario Securities Act, 1978, s. 130 (a person who "trades in" a security without sending a takeover bid circular "is liable to his...offeree for rescission or damages").

116 See section 2.48.

117 See e.g. sections 2.07, 2.14; and see generally part 12.

118 See *ALI FEDERAL SECURITIES CODE*, ss. 299.12, 299.46(b).

119 See sections 2.32, 2.40 ("any act...in furtherance of"); cf. Ontario Securities Act, 1978, s. 1(1)42(v).

120 See *Grover & Baillie*, n. 333; cf. *ALI FEDERAL SECURITIES CODE*, Tent. Draft No. 1, s. 293(f), Comment (3); and see paragraph 2.17(a) ("distribution").

121 See e.g. sections 2.17, 5.02.

122 See e.g. Ontario Securities Act, 1978, s. 1(1)42(ii).

ceipt by a registrant of an order to buy or sell a security".¹²³ The provision first appeared in connection with the addition of prospectus requirements to the Ontario Securities Act in 1945, presumably to facilitate prosecution of registrants who sold securities in violation of the prospectus requirements.¹²⁴ It has been omitted from the Draft Act because it is unnecessary in light of the extended definition of "sale".¹²⁵ In any event it would be unnecessarily harsh to create, as an aid to enforcement, a violation of the passive receipt of an order to buy, especially in light of the potential civil liability under part 13.¹²⁶

Finally, it is unnecessary to expressly include a "pledge" in the definition of "trade", as such transactions are "dispositions" within section 2.40.

**Sections 2.34, 2.35, 2.36, 2.37 and 2.38: "Records",
"Registrant", "Regulated Financial Institution", "Reporting
Issuer" and "Right to Acquire a Security"**

The definitions of these terms are included to facilitate the drafting of the substantive provisions. The first, "records", encompasses all documents and information relating to a business, however recorded and kept. The term is applicable to the activities of all registrants and to those of the Commission. Therefore it specifies, in addition to documents and microfilm records, information that may be stored and retrieved by computer which is likely to become the major method used by the exchanges, clearing agencies and the Commission to maintain information.

Registrants are simply persons who become registered under the Draft Act and thus include brokers, dealers and other securities professionals who register under part 8 and self-regulatory organizations registered under part 9. The source provisions define "registrant" to include a person who is required to become registered and thus cover persons who trade without registration. The Draft Act omits the latter class from the definition because the term is frequently used in a sense limited to persons who are registered, especially in connection with distributions.¹²⁷ In the event that an unregistered person carries on business in a manner that would violate a duty imposed on a registrant, it will be sufficient to prosecute for his failure to obtain registration.

123 Ontario Securities Act, 1978, s. 1(1)42(iii).

124 See S.O. 1945, c. 22, s. 1(q)(iv); cf. Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. AD. 172, 196 (1965).

125 See section 5.02.

126 Cf. Baillie, *supra* note 124, n. 96.

127 See e.g. sections 5.03, 6.04.

"Registrant" does not, however, include a reporting issuer. A "reporting issuer" is an "issuer" that has filed a "registration statement" under part 4.¹²⁸ Because in most cases no approval by the Commission is involved, such a filing is not equivalent to registration under parts 8 and 9.¹²⁹ Nevertheless, the concept of a reporting issuer is basic to the Draft Act and provides a foundation for the continuous disclosure requirements of part 7 and for special treatment in other regards.¹³⁰ The second clause is included in the definition to ensure that an issuer that has ceased to be a reporting issuer is neither subject to part 7 nor entitled to be treated as a reporting issuer.¹³¹

"Regulated financial institutions" are essentially financial intermediaries such as insurance corporations, loan and trust corporations and mutual funds, which invest in or sell securities and the activities of which are regulated by a government agency other than the Commission. The term also includes financial intermediaries such as banks which are not as actively involved in the securities markets. As section 3.02 exempts the specified institutions from disclosure requirements, status as a regulated financial institution is contingent upon the existence of comparable disclosure requirements under their regulatory legislation.¹³² Regulated financial institutions are entitled to become participants in a clearing agency and the Commission is required to cooperate with the agency responsible for supervision of their activities in enforcement proceedings.¹³³

Finally, "right to acquire a security" is used in several other definitions and in relation to short sales.¹³⁴ Essentially, it is intended to subsume in the short phrase all types of rights to acquire such as conversion rights, warrants and other currently exercisable options. Paragraphs (a) and (c) derive primarily from the Canada Business Corporations Act and paragraph (b) from the *ALI Code*.

128 See section 2.38.

129 Cf. ALI FEDERAL SECURITIES CODE, ss. 299.40, 405.

130 See e.g. section 6.04 ("trading transaction" exemption from part 5).

131 See section 4.05.

132 See section 3.02, Commentary.

133 See sections 9.03, 10.18, 15.12.

134 See sections 2.09 ("call"), 2.18 ("equity security"), 12.03 (short selling by insiders), 12.08 (short tendering).

Section 2.42: “Securities Exchange”

Securities exchanges are the third and final type of self-regulatory organization defined in the Draft Act.¹³⁵ Like the other types of organization, a securities exchange is defined in terms of its public functions, namely, the providing of a public marketplace for trading in securities. The section is framed to include the present exchanges which maintain trading floors on which their members execute trades, as well as the exchange of the future which is likely to be an automated nationwide, or possibly international, trading system. Paragraph (a) describes the former type of exchange and paragraph (b) the latter. Because paragraph (a) defines a marketplace by describing its functions, there is no need to include the term expressly as the source provision does. For the same reason paragraph (b) does not expressly refer to the “bringing together of buyers and sellers”. Nor is it necessary to include the facilities themselves, for all such facilities and systems will be provided or maintained by some sort of organized human effort, that is, by a person.¹³⁶

Paragraph (b) specifies two elements, a system which facilitates trading and the means of doing so, namely, by matching offers to buy or sell securities. The second element is necessary to exclude electronic or other systems that perform the former function but are only tangentially related to a securities exchange, for example, telephones and wire services that report trading. However, the fact that the paragraph refers only to the matching of purchasers and sellers gives the definition substantial breadth so that it includes all automated trading systems that pair or compare offers whether or not they are capable of executing trades. Although “matching” of orders in a *clearing* system involves equalization and pairing, the word in common usage is capable of other meanings as well, for example, comparing and collating, and it is in the latter sense that it is used in the section.¹³⁷ As a result, systems such as Instinet which match bid and ask quotations but leave the execution of trades to be completed by the buyer and seller outside of the system are required to register as exchanges under part 9 of the Draft Act.

Similarly an in-house computer operated by a securities firm or other financial institution to facilitate its own trading constitutes the firm or institution an exchange within section 2.42 that is subject to the requirements of part 9. The source provision

135 See also sections 2.05, 2.10 and Commentary.

136 See section 2.29.

137 Cf. section 12.06 and Commentary.

excludes this type of system from the definition of exchange unless the Securities and Exchange Commission provides otherwise either generally or in a particular case.¹³⁸ The Draft Act reverses the burden and requires all such persons to register unless they obtain an exemption from the Commission. The Commission may, of course, promulgate regulations exempting any class of persons from any provision of part 9.¹³⁹

A securities exchange is defined exclusively in terms of the provision of a marketplace for securities transactions, even though the existing stock exchanges in Canada also regulate entry into and prices for services in the securities market and supervise their members' conduct for compliance both with their own rules and with the securities laws. The limited definition of an exchange is intended to focus on the essential functions of such organizations. The other self-regulatory functions performed by them bring them within the definitions of "association of securities firms" and "clearing agency", the other types of self-regulatory organization. As was said above, it is expected that the Commission will establish procedures and standards for registration that will enable an organization which performs all three types of functions to obtain a single registration.¹⁴⁰

Section 2.44: "Securities Register"

The major use of "securities register" is in part 10 of the Draft Act in connection with the deposit of securities in a clearing agency or the recording of issues and transfers by means of a book entry system. The definition is included in this Part, however, because it is used as well in section 16.13 which permits reliance on an issuer's securities register to determine the number or percentage of outstanding securities for purposes of compliance with the requirements of the Act. The definition is, therefore, framed in functional terms so that it includes the securities registers required under all corporation laws.¹⁴¹

Section 2.45: "Security"

The definition of "security" is perhaps the most important in the Draft Act for all of the substantive provisions are based upon it. The definitions in the provincial statutes have been called a

138 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 232A, Comment (2).

139 See section 3.03.

140 See section 2.10, Commentary.

141 See e.g. Ontario Business Corporations Act, ss. 157-160; British Columbia Companies Act, S.B.C. 1973, c. 18, ss. 63-68.

"heterogeneous clutter" to which "the defining terms seem to have been added piecemeal, and without much justification".¹⁴² The accuracy of this description has been confirmed in recent years by additions that incorporate the most recent types of investment contracts into the definition.¹⁴³ Although the Draft Act relies to a large extent on the provincial source provisions, an attempt has been made to consolidate the definition by reorganizing its structure and by deleting parts that are redundant.¹⁴⁴

The structure of the definition is essentially as follows. Interests that are commonly considered securities are first specified in paragraph (a) which includes a general statement of the category itself in subparagraph (a)(v). The definition then adopts a number of the particular provisions from the provincial statutes and is rounded off by the broad terms "investment contract" (paragraph (f)) and any "right to acquire or sell" a security previously specified (paragraph (g)). (A right to sell a security is expressly included to ensure that puts come within the definition.) A "security" is thus broadly defined and would, without more, include a number of financial arrangements that are not commonly thought of as securities and that for one reason or another do not require the type of protection provided by securities legislation. Section 2.45 therefore proceeds to exclude several such instruments from the definition of "security" and thus from the coverage of the Draft Act itself.¹⁴⁵

The provincial acts, with a few exceptions, define a security in terms of a written instrument or document. (The exceptions are an "interest" in an oil or natural gas lease, and, possibly, an agreement to subscribe to securities when issued, a profit-sharing agreement and an investment contract.¹⁴⁶) Although in most cases a security will be evidenced by a written instrument of some sort, it has been suggested that the general limitation may "leave a loophole for the sale of interests identified only in a register book".¹⁴⁷ This potential gap assumes increasing importance in light of the movement toward book entry systems to record the ownership and transfer of securities.¹⁴⁸ The Draft Act, therefore, adopts the approach in the U.S. source provision and expressly includes both "interests" and "instruments" so that a "security"

142 J. WILLIAMSON, SUPP. at 100.

143 See e.g. Ontario Securities Act, 1978, ss. 1(1)40(xv)-(xvi); cf. Ontario Bill 7 (2d reading), ss. 1(1)40(xv)-(xvii).

144 Cf. *Pacific Coast Coin Exchange of Canada vs. OSC*, 80 D.L.R. (3d) 529, 538 (S.C.C. 1977).

145 See paragraphs (h)-(k).

146 See e.g. Ontario Securities Act, 1978, ss. 1(1)40(vii), (ix), (xiv).

147 J. WILLIAMSON, SUPP. at 102.

148 See e.g. part 10 and Commentary.

clearly includes interests that are not reduced to writing or for which a certificate is not issued.¹⁴⁹ Subparagraph (a)(v) thus uses "instrument" generically to include any written evidence of a security and omits as redundant the words used in the provincial legislation.¹⁵⁰

A broad definition of "security" is necessary to ensure that the Draft Act covers the variety of investment vehicles that have been and may be devised to obtain funds from investors, as has been demonstrated in the cases that have arisen. Courts in the United States have treated securities laws as remedial and in order to effectuate their purpose have long interpreted an "investment contract" (paragraph (f)) and an "interest...commonly known as a security" (subparagraph (a)(v)) to accomplish their ends. The federal courts have generally followed the test enunciated by the Supreme Court in *SEC v. W.J. Howey Co.*¹⁵¹ and have looked through form to the substance of a transaction to determine whether a "security" is involved on the basis of the existence of four factors, namely, (1) the payment of money by an investor (2) in the expectation of profits (3) from a common enterprise (4) primarily through the efforts of others. (Although the Supreme Court said "solely" rather than "primarily", subsequent decisions have interpreted its statement broadly to encompass, in effect, the latter type of conduct as well.¹⁵²) State courts, on the other hand, have adopted a seemingly broader test, the "risk capital test", based upon the transfer of money by an investor who accepts the risk of success of an enterprise that is not subject to his control in the expectation of some benefit, whether or not monetary.¹⁵³

It might be argued that the results under either test will be the same in most cases. However, such an investigation is unnecessary as the Supreme Court of Canada has recently accepted both the risk capital and the *Howey* tests when interpreting the meaning of "investment contract" under the provincial securities legislation.¹⁵⁴ The Court not only adopted the remedial approach to

149 See e.g. subparagraph (a)(v) and paragraph (b); cf. ALI FEDERAL SECURITIES CODE, s. 299.53, Revised Comment (1)(b); and see, *Iacobucci* following n. 403.

150 See e.g. Ontario Securities Act, 1978, s. 1(1)40(i) ("any document, instrument or writing").

151 66 S. Ct. 1100 (1946).

152 See e.g. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973).

153 See e.g. *Hawaii v. Hawaii Market Center, Inc.*, 485 F.2d 105 (Hawaii 1971); *Silver Hills Country Club v. Sobieski*, 361 F.2d 906 (Calif. 1961); and see generally, *Iacobucci*, chs. IV.B-D(1).

154 See *Pacific Coast Coin Exchange of Canada v. OSC*, *supra* note 144.

securities legislation generally accepted by U.S. courts,¹⁵⁵ but it expressly affirmed the recent broad reading of the *Howey* test, citing the *Glenn Turner* decision,¹⁵⁶ including its interpretation of the third factor, common enterprise, to encompass vertical as well as horizontal commonality, that is, to encompass the relationship "between the investor and the promoter" as well as between investors.¹⁵⁷ As a result of the Supreme Court's expansive interpretation, Professor Iacobucci's conclusion concerning the ultimate futility of attempts to develop a comprehensive definition of "investment contract" is compelling and the Draft Act does not do so.¹⁵⁸ It is expected, however, that the Supreme Court of Canada will not follow its U.S. counterpart in all respects.¹⁵⁹

In light of the judicial interpretation of "investment contract" and especially of the Supreme Court's expansive reading, a number of provisions included in the source sections have been dropped as superfluous. For example, the second item in the provincial acts has been criticized as being possibly too broad.¹⁶⁰ In fact, both the *Dalley* case and *R. v. Boughner*¹⁶¹ which were decided under the equivalent definition in the source provisions involved "investment contracts".¹⁶²

Similarly the provision dealing with agreements to treat money as a subscription to securities has been omitted as redundant in light of the inclusion of a "preorganization certificate or subscription" in subparagraph (a)(iii).¹⁶³ An interest in "an association of legatees or heirs" received the same treatment as it is clearly included in subparagraph (b)(ii) as an interest in an "association".¹⁶⁴ And oil and natural gas royalties or leases are not separately specified in the Draft Act as they fall within subparagraph (b)(iii).¹⁶⁵

While it might be argued that all of paragraph (b) could be deleted on the basis that the interests specified therein are

155 See *id.* at 538.

156 *Id.* at 539-40.

157 *Id.* at 540; see also, Iacobucci, ch. V.B(1)(f).

158 See *id.* following n. 408; see also *Pacific Coast Coin Exchange of Canada v. OSC*, *supra* note 144, at 542 ("courts should seek to attain...[the goals of the legislation] even if tests carefully formulated in prior cases prove ineffective and must be continually broadened in scope").

159 Cf. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), discussed in, Iacobucci at nn. 205-09; compare *Silver Hills Country Club v. Sobieski*, *supra* note 153; *In re Avoca Apartments Ltd.*, [1968] OSC Bull. 154 (July).

160 See e.g. Ontario Securities Act, 1978, s. 1(1)(40)(ii); and see J. WILLIAMSON, SUPP. at 102-05, citing *R. v. Dalley*, 8 D.L.R. (2d) 179 (Ont. C.A. 1957).

161 [1948] O.W.N. 141 (H.C.) (sale of half interest in pair of chinchillas).

162 See, Iacobucci at nn. 51-53, 306-07, 409-10.

163 See e.g. Ontario Securities Act, 1978, s. 1(1)(40)(vii); see also, Iacobucci at n. 414a.

164 See e.g. Ontario Securities Act, 1978, s. 1(1)(40)(iii); cf. J. WILLIAMSON, SUPP. at 108.

165 See e.g. Ontario Securities Act, 1978, s. 1(1)(40)(xi); cf. Iacobucci at nn. 58-59.

commonly known as securities¹⁶⁶ and that interests in profit-sharing agreements would likely be commonly known as securities or investment contracts and also would involve participation certificates within subparagraph (a)(ii), subparagraphs (b)(i) and (iii) have consistently been the subject of specific attention in securities legislation throughout North America and for that reason have been retained here. Paragraphs (c) to (e) are included as specific illustrations of securities for similar reasons¹⁶⁷ and subparagraph (b)(ii) makes clear that interests in non-profit associations are covered to avoid any uncertainty that may result from the meaning of "investment contract".¹⁶⁸

A number of other elements of the definition of "security" in the provincial acts have also been omitted. For example the Ontario Securities Act, s. 1(1)22(xiv), includes documents "constituting evidence of an interest in a scholarship or educational plan or trust" as securities and Bill 7 (2d reading), s. 1(1)40(xvi), added documents evidencing a sharing agreement in real property that limits use of the property to specific periods of time during each year. Both have been omitted from the Draft Act as they are already included as "investment contracts".¹⁶⁹

A number of American state statutes include as securities commodity futures contracts and options to trade in such contracts if they are not regulated under federal legislation or traded on a regulated commodities exchange¹⁷⁰ and the new Ontario act contains a similar provision relating to its companion act, The Commodity Futures Act, 1978.¹⁷¹ The *ALI Code* takes the opposite approach and excludes "a commodity contract (whether for present or future delivery) or [a] warrant or right to buy or sell such a contract".¹⁷² The Draft Act does neither; commodity futures and interests in them are subject to the act, like other unusual or hybrid types of security, only if they constitute an "investment contract".¹⁷³

Nevertheless, as is mentioned above, the broad scope of the definition encompasses a number of instruments and financial arrangements that are not commonly thought of as securities or

166 Cf. J. WILLIAMSON, SUPP. at 108.

167 Cf. *Iacobucci* following n. 410.

168 Cf. e.g. *Silver Hills Country Club v. Sobieski*, *supra* note 153; *United Housing Foundation, Inc. v. Forman*, *supra* note 159.

169 See e.g. *Iacobucci* at n. 416.

170 See e.g. *Alaska Securities Act*, s. 45.55.130(12); *Oklahoma Securities Act*, s. 2(19)(0).

171 See *Ontario Securities Act*, 1978, s. 1(1)40(xvi).

172 *ALI FEDERAL SECURITIES CODE*, s. 299.53(b)(8); and see *id.* Revised Comment (7).

173 Cf. *Pacific Coast Coin Exchange of Canada v. OSC*, *supra* note 144; Bromberg, *Commodities Law and Securities Law-Overlaps and Preemptions*, 1 J. CORP. L.

for which the protection afforded by the Draft Act is unnecessary and that for these reasons should be excluded from the Draft Act.

As the reasons for exclusion of such instruments vary, the Draft Act deals with them severally in order to harmonize the basis of the exclusion with the protection of investors and the scheme of the act. First, instruments that because of their nature or because of the minimal risk associated with them should not be subject to the Draft Act in any circumstances are expressly excluded from the definition of "security" itself and are thus neither subject to the requirements of the Draft Act nor to the Commission's discretion to make them so. Financial arrangements that are not within this group are dealt with in the other parts of the Draft Act to ensure that exemptions are considered in relation to the various substantive provisions. Thus part 3 contains exemptions from the whole of the Draft Act and from its disclosure provisions, part 6 from the prospectus provisions and part 8 from the registration requirements, but all are subject to denial by the Commission in appropriate circumstances.¹⁷⁴

The exclusions from the definition of "security" are relatively straightforward. As paper currency consists of notes issued by a government body such as the Bank of Canada in Canada,¹⁷⁵ it is within the literal meaning of "security".¹⁷⁶ Paragraph (h) therefore excludes it.

It is worth emphasizing that paragraph (h) and the other exclusions remove from the definition only the precise type of instrument specified. Thus while currency is not a "security", various types of interests in currency, such as a discretionary account to invest in futures in Canadian dollars or the sale of silver coins under certain arrangements, may be investment contracts within paragraph (f) subject to the Draft Act.¹⁷⁷

Similarly the items excepted by paragraph (i) constitute "evidence of indebtedness" and would otherwise be subject to the Draft Act. (The last, a letter of credit from a bank, is included out of caution.¹⁷⁸) The *ALI Code* excepts as well promissory notes issued in consumer and mercantile transactions. Although such notes are also regulated by the Bills of Exchange Act,¹⁷⁹ they are

221-67 (1976); and see, *Iacobucci*, chs. IV.D(3), V.B(1); *Searsy v. Commercial Trading Corporation*, 3 CCH BLUE SKY L. REP. ¶ 96,276 (Tex. 1977).

174 See generally part 3 and Commentary.

175 See Bank of Canada Act, R.S.C. 1970, c. B-2, s. 21.

176 See paragraph (a)(i); cf. *Bank of Canada v. Bank of Montreal*, 76 D.L.R. (3d) 385 (S.C.C. 1977).

177 Cf. *Pacific Coast Coin Exchange of Canada v. OSC*, *supra* note 144.

178 Cf. *ALI FEDERAL SECURITIES CODE*, s. 299.53(b)(2).

179 R.S.C. 1970, c. B-5, part IV.

not included among the exclusions in section 2.45 because the manner in and purpose for which they are issued may make them investments rather than a method of financing the purchase of consumer goods. In order to include a similar limitation the *ALI Code* limits the exception to situations in which the issue of a note does not involve a distribution. This approach may, however, involve difficult interpretative questions and in any event the definition of "distribution" in the Draft Act differs from that in the Code.¹⁸⁰ As a result, such notes are exempted from the whole of the Draft Act by section 3.01 subject to the Commission's power to deny the exemption in circumstances in which it should not be available.¹⁸¹

Paragraph (j) excludes deposit accounts with banks, credit unions and other deposit-taking institutions because such accounts usually involve evidence of indebtedness and may involve an investment contract. Again, these accounts do not involve the types of arrangement that require the protection of the Draft Act. Not all accounts are investment vehicles and even those that are, particularly savings accounts, are well known and involve minimal risk. The exception in the *ALI Code* is framed in terms of "an interest" in a bank deposit account "but not a participation in such interests".¹⁸² The Draft Act excepts the deposit account itself which implicitly carries with it "an interest" in or evidence of one,¹⁸³ and makes clear that a "participation in" a deposit account that constitutes an investment contract is not excluded.¹⁸⁴

The paragraph thus attempts to exclude all deposit-taking institutions. Banks are expressly included as the prototypical example; credit unions are included separately and by reference to the Income Tax Act because the definition in the latter act includes all credit unions in Canada regardless of the variations in the provincial legislation governing them and because it is not clear that all credit unions are subject to a deposit insurance scheme. Subparagraph (j)(iii) is intended to include all other deposit-taking institutions operating in Canada. A member institution under the Canada Deposit Insurance Corporation Act is one

180 Compare section 2.17 and ALI FEDERAL SECURITIES CODE, s. 242(a)(1) (latter section excludes limited offerings whereas former does not); cf. section 6.03.

181 See section 3.04; cf. *Oklahoma v. Hoephner*, 3 CCH BLUE SKY L. REP. ¶ 71,397 (Okla. C.C.A. 1978).

182 ALI FEDERAL SECURITIES CODE, s. 299.53(b)(4); cf. Ontario Securities Act, 1978, s. 1(1)40(v) ("an evidence of deposit issued by a bank" or a loan or trust corporation incorporated in Ontario).

183 Cf. paragraph (b).

184 See Commentary above discussing paragraph (h).

that has deposits insured by the corporation¹⁸⁵ and the remainder of the subparagraph applies the same criteria to institutions that participate in a similar provincial scheme.¹⁸⁶

Most insurance policies and income and annuity contracts issued by an insurance corporation have long been exempted from securities legislation, presumably because they are not commonly known as securities and because insurance corporations are subject to a separate regulatory regime. The Draft Act does not depart from this policy but it does differ in method.

The Ontario provisions expressly include in the definition of security income or annuity contracts "not issued by an insurance company or an issuer within the meaning of *The Investment Contracts Act*".¹⁸⁷ Paragraph (k) expressly excludes fixed income and fixed annuity contracts issued by an insurance corporation. Again, however, hybrid securities involving aspects of annuity contracts along with other terms that bring them within paragraph (f) ("investment contract") are not within the exclusion and thus remain subject to the Draft Act. This fact is emphasized by the adjective "fixed" and by the express inclusion of variable annuities in subparagraph (a)(iv).¹⁸⁸

Similarly, the new Ontario act expressly excepts insurance contracts providing for payment at maturity of at least three-quarters of the premiums paid by the purchaser.¹⁸⁹ The Draft Act leaves such specific conditions to the Commission's discretion under section 3.04 so that appropriate criteria may be developed on the basis of the experience of the provincial commissions and the Commission.¹⁹⁰

The Ontario provisions also use a similar approach to investment contracts. They include as securities only those that are not "investment contract[s] within the meaning of *The Investment Contracts Act*". Such contracts are presumably excluded on the same basis as annuities issued by an insurance corporation. Investment contracts, however, may take many forms including savings certificates, and while issuers are required to maintain reserves, the Investment Contracts Act does not prescribe disclosure to purchasers of such contracts.¹⁹¹ Moreover, not all of the provincial

185 See R.S.C. 1970, c. C-3, s. 2.

186 Cf. Bankruptcy Act, 1978, Bill S-11, 30th Parl., 3d Sess., ss. 33(1), 100(2) (First reading March 21, 1978).

187 See e.g. Ontario Securities Act, 1978, s. 1(1)40(xii); see also *id.* s. 1(1)40(v) (insurance policy).

188 Cf. *Iacobucci* at nn. 143, 197-201a.

189 See Ontario Securities Act, 1978, s. 1(1)40(vi).

190 See also paragraph 3.02(1)(c).

191 See Investment Contracts Act, R.S.O. 1970, c. 226, ss. 1(b), 10.

securities acts contain a similar exemption.¹⁹² As a result such securities are treated like the securities of regulated financial institutions and are left to be dealt with as substantive exemptions from the Draft Act. Accordingly, the Commission may prescribe limiting conditions or extend the exemption to existing investment contract corporations as it can for variable annuities.¹⁹³ Savings certificates issued by banks and other financial institutions are treated in the same manner in order to permit the Commission, if necessary, to impose conditions relating to the method of sale.¹⁹⁴

Section 2.46: “Self-Regulatory Organization”

“Self-regulatory organization” is included as a separate definition primarily to facilitate drafting. It comprises in a single term the three types of self-regulatory body that are subject to the Draft Act and that perform all self-regulatory functions in the securities industry.¹⁹⁵ Despite the functional differences of the three types of organization, their treatment under the Draft Act derives from identical conceptual underpinnings. The single term highlights this fact and is useful where all self-regulatory organizations are dealt with generically.¹⁹⁶

Section 2.49: “Underwriter”

As stated above, an “underwriter” is a person who distributes securities for others, either as principal or agent.¹⁹⁷ Although the definition derives primarily from the Ontario source provisions, the language has been condensed somewhat in light of other definitions in this Part. For example, the Ontario provisions include a person who “agrees to purchase” or who “offers for sale or sells” securities. In light of the wide definitions of “purchase” and “sale” in sections 2.32 and 2.40, the Draft Act simply refers to persons who purchase or sell. Indeed, the definitions of “purchase” and “sale”, combined with the inclusion of participants, make the definition of “underwriter” sufficiently broad to include all persons who aid in a distribution.¹⁹⁸

It is necessary, therefore, as with some of the other defini-

192 See e.g. *Iacobucci* at n. 62; J. WILLIAMSON, SUPP. at 112.

193 See paragraph 3.02(1)(c).

194 Cf. ALI FEDERAL SECURITIES CODE, s. 299.53(b)(5); and see paragraph 3.01(c).

195 See sections 2.05, 2.10, 2.42.

196 See e.g. sections 8.02, 15.18; and see generally part 9.

197 See section 2.02, Commentary.

198 Cf. *SEC v. Chinese Consolidated Benevolent Ass'n, Inc.*, 120 F.2d 738 (2d Cir. 1941), cert. denied, 314 U.S. 618 (1941); see also D. JOHNSTON at 80.

tions, to limit the scope of “underwriter” in relation to its usage in the Draft Act. The primary functions of the definition are to describe activities that require registration and to designate responsible persons for purposes of civil liability.¹⁹⁹ In these cases the persons who should be included are, respectively, those who are carrying on business as underwriters and those who are consciously and directly involved in a distribution of securities that is subject to the prospectus requirements. The Draft Act accomplishes these results both in the definition itself and in the substantive provisions.

Only a person who carries on business as an underwriter is required to register as such and civil liability for a false prospectus is limited to underwriters who sign the prospectus. Similarly, a failure to file a prospectus may result in substantially greater liability against an underwriter than against other selling registrants.²⁰⁰ The limitations are further refined by section 2.49 itself which excludes from the meaning of “underwriter” persons who either have no control over the terms of an underwriting or who are inadvertent distributors. Thus paragraph (c) excludes members of a selling group, that is, brokers and dealers who sell securities in a distribution but who have no involvement in fashioning its terms and who receive only a commission or discount from the lead underwriter.²⁰¹ As the seller’s commission is usually received from the lead underwriter even in an agency underwriting, there is no need to include issuers and selling securityholders in the paragraph.²⁰² In any event members of the selling group are securities professionals and as such are required to register as brokers or dealers. Therefore their exclusion from the definition does not create a gap in the Draft Act’s coverage.

Paragraph (d) is intended to except persons who inadvertently come within the terms of the section. This exception is necessary because of the Draft Act’s structure. Briefly, a prospectus must be filed under part 5 where a distribution occurs unless an exemption under part 6 is available. However, the fact that a particular transaction comes within an exemption under part 6 does not make it any less a “distribution”. Indeed, an exemption from part 5 is necessary only where a trade does constitute a distribution.²⁰³ As a result a broker who sells for an issuer pursu-

199 See generally parts 8, 13.

200 See sections 8.01, 13.02, 13.05.

201 For a brief description of underwriting in Canada, see J. WILLIAMSON, ch. 11; J. WILLIAMSON, SUPP. ch. 11; and see, *Williamson, Financial Institutions*, ch. II.3.C.

202 But cf. Ontario Securities Act, 1978, s. 1(1)43(i) (includes issuer).

203 Compare ALI FEDERAL SECURITIES CODE, s. 242(a) (limited offerings and trading transactions not distributions).

ant to the trading transaction exemption in section 6.04 would be an underwriter but for paragraph (d); and the same is true with regard to sales for a secondary distributor, for a sophisticated purchaser and even for a person who sells before a prescribed holding period has expired.²⁰⁴

The limitations in paragraph (d) are intended to ensure that no special compensation is received in connection with the trade so that only legitimate market transactions are excepted from the definition. As with the preceding exception, persons who are within the exception must register under the Draft Act in any event. However, neither paragraph (c) nor (d) includes persons who arrange private placements or who manage limited offerings for a fee. Those who carry on a business in exempt distributions must, therefore, obtain registration as underwriters. But as a prospectus is not required in any of these situations, they are not subject to liability as underwriters under part 13.

The breadth of the Canadian source provisions derives not only from the inclusion of participants in a distribution, but also from the broad prepositions used in the definition. Under the provincial legislation an underwriter is a person who "agrees to purchase securities *with a view to* distribution or who, as agent, offers for sale or sells securities *in connection with* a distribution".²⁰⁵ There has been no formal consideration in Canada of the meaning of these prepositions and the question is not raised in the most recent Canadian text on the subject.²⁰⁶ However, the definition was taken almost verbatim from a similar provision in the Securities Act of 1933, s. 2(11), and the former preposition has given rise to some difficulties in the United States.²⁰⁷ In fact, the difficulties are sufficiently complex that both prepositions have been removed from the definition of underwriter in the *ALI Code*.²⁰⁸

In light of the extended definition of "distribution" in section 2.17, the retention of the prepositions in section 2.49 would make the definition of underwriter far wider than necessary in that it would include persons who purchase pursuant to an exemption in part 6 with a view to resale pursuant to another exemption in the Part. To avoid this difficulty the Draft Act substitutes for both prepositions the words "*in furtherance of* a distribution" so that

204 See section 2.17 and Commentary.

205 Ontario Securities Act, 1978, s. 1(1)43 (emphasis added).

206 See D. JOHNSTON at 80-82.

207 See e.g. SEC v. Guild Films Company, Inc., 279 F.2d 485 (2d Cir. 1960), *cert. denied*, 364 U.S. 819 (1960); see generally 1 L. Loss at 551-53, 642-51; 4 *id.* at 2580, 2621-27.

208 See ALI FEDERAL SECURITIES CODE, s. 299.74 ("buys...in aid of a distribution of the issuer's securities").

“underwriter” is more narrowly defined and is limited to persons whose conduct is actually in aid of a distribution.²⁰⁹

The new Ontario act excepts from the definition of “underwriter” banks that distribute debt securities issued by a government or an exempt financial institution and thus by implication includes them when they distribute other securities.²¹⁰ The provision was presumably included in light of the recommendations in the federal government’s white paper on banking that would have permitted banks to underwrite the specified securities but to act only as members of the selling group in relation to other securities.²¹¹ The Draft Act does not contain a provision like that in the Ontario act. The securities that banks are permitted to underwrite are exempt from the prospectus and other disclosure requirements,²¹² and registration as an underwriter in relation to such activities is dealt with in part 8 as a matter of substance so that the Commission may deny an exemption in appropriate circumstances.²¹³ In any event a bank is not an “underwriter” in respect of its activities as a member of the selling group for other securities.²¹⁴

Finally, paragraph (e) excepts issuers. As an issuer must either file a prospectus or find an exemption when it resells securities of its own issue repurchased by it, there is no need to require it to register as an underwriter. However, the exception is limited to the type of distribution specified in paragraph (e). An issuer may be an underwriter if it acts in furtherance of a distribution by another person, for example, a controlling securityholder who sells securities of its issue.

209 Cf. ALI FEDERAL SECURITIES CODE, s. 299.74, Revised Comment (2).

210 See Ontario Securities Act, 1978, s. 1(1)43(iv).

211 See WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION 35 (August 1976); see now Banks and Banking Law Revision Act, 1978, Bill C-57, 30th Parl., 3d Sess., ss. 89(5), (6) (First reading May 18, 1978).

212 See paragraphs 3.02(1)(a)-(c).

213 See section 8.01 and paragraph 8.06(3)(b).

214 See paragraph (c).

Part 3

Exemptions

The definition of “security” brings under the Draft Act a large number of financial instruments that are not commonly considered or treated as securities, or that for other reasons, such as the minimal amount of risk associated with them, do not give rise to the need for the investor safeguards that the Draft Act is intended to provide.¹ As a result it is necessary to confine the scope of the act’s application in order to eliminate such interests.

The confinement is accomplished in a number of ways. The geographical reach of the Draft Act is specified in part 16 which, in effect, limits its application to persons whose conduct affects Canadian investors or the Canadian securities market in some manner.² More directly, the substantive provisions themselves apply only to the persons specified in them, usually on the basis of an express standard which is a prerequisite to their invocation. Part 8, for example, is limited to securities professionals by the specification of persons engaging in defined conduct as a business.³ And the application of all provisions of the Draft Act is limited by the exceptions in the definition of “security” itself.⁴

Nevertheless, the breadth of the definition necessitates further confinement of all or substantial parts of the Draft Act in relation to instruments or activities which for one reason or an-

1 See section 2.45 and Commentary.

2 See section 16.02.

3 See section 8.01.

4 See paragraphs 2.45(h)-(k) and Commentary.

other do not generally require the protection afforded by the act or a particular set of provisions in it but which may in some circumstances warrant their application. The exclusion of such securities and activities is accomplished by the use of exemptions which, unlike exceptions from the definitions, may be denied or modified by the Commission in appropriate circumstances.

The pattern of exemptions is relatively straightforward. Part 3 exempts specified securities from all or part of the Draft Act, part 6 exempts certain transactions from the prospectus requirements in part 5 and part 8 contains exemptions from the registration requirements. In addition, the Commission is authorized to grant further exemptions both generally and in particular cases. Part 3 contains the Commission's general exempting power and two classes of exempt securities; the first from all of the provisions of the Draft Act other than those empowering the Commission to deny exemptions and to conduct investigations, and the second from the disclosure requirements applicable to issuers and to distributions. The former category includes instruments commonly traded in a well-defined commercial context so that the parties do not require the protection of the Draft Act even in relation to fraud. The Commission's discretion to deny is likely to be invoked in relation to such securities only where they are traded in an extraordinary manner that exposes investors to the consequences at which the act is directed. (The Commission's powers of investigation are retained so that the Commission may discover the facts necessary to a determination to initiate proceedings to deny such an exemption.) The latter category is composed of securities that are issued by corporations subject to disclosure requirements under other regulatory legislation or that are sufficiently secure to make unnecessary the disclosure requirements usually required to protect investors. Such securities are, however, subject to the anti-fraud and enforcement parts of the Draft Act, and registration of persons who carry on a business of trading in them may be required. In either instance the Commission may deny an exemption in appropriate circumstances and the burden of proving entitlement to an exemption is on the person claiming it.

Section 3.01

Section 3.01 contains the exemptions from all provisions of the Draft Act other than those empowering the Commission to conduct investigations, bring enforcement proceedings, and deny an exemption if necessary for the protection of investors. The securities specified in the section are traded in a well-defined commercial context or are sufficiently secure that in ordinary circum-

stances the application of the Draft Act would interrupt the functioning of the market with minimal, if any, benefit to the persons involved.

Paragraph (a) exempts, in effect, transactions in the money market which, in Canada, is essentially the exclusive preserve of the money market dealers who have a line of credit from the Bank of Canada by means of purchase and resale agreements.⁵ At present there are only thirteen such dealers, all of whom are subject to regulation by the Bank of Canada. And all thirteen are members of the Investment Dealers Association of Canada which also establishes standards for money market dealing.⁶ Moreover, there is no public trading market in money market instruments; any trading that occurs is between dealers and sophisticated purchasers who are capable of protecting themselves, and the possible loss by a dealer of access to "the window" at the Bank of Canada provides a more than sufficient sanction in relation to such trading. As a result, the money market is highly regulated and not even part 12 of the Draft Act need apply to it.⁷

The exemption is limited to the short-term paper market by specification of the maximum term and the minimum amount of any note. The present provincial securities acts contain the same limitations.⁸ Although some consideration was given to increasing the minimum amount, possibly to \$100,000, in light of inflation and the fact that the "usual trading unit" in the money market was that amount in 1962,⁹ the \$50,000 figure was not altered because both the most recent provincial legislation and the legislative proposals in the United States have retained it.¹⁰ If it becomes clear in the future that the amount is too low, the paragraph permits the Commission to increase it by regulation.¹¹

The exemption in paragraph (a) also includes the issuance of notes by corporations as a method of obtaining short-term financing. However, the restrictions on the availability of the exemption make it likely that exempt instruments will be sold only to purchasers who are sufficiently sophisticated to protect themselves¹² through dealers who remain subject to the "suasion" of the Bank of Canada. As a result the potential for abuse in relation to

5 See, *Williamson, Financial Institutions*, ch. II.3.D; D. FULLERTON, *THE BOND MARKET IN CANADA*, ch. 11 (1962); PORTER REPORT at 318.

6 See, *Williamson, Financial Institutions*, *supra* note 5.

7 Cf. PORTER REPORT at 321.

8 See *e.g.* Ontario Securities Act, s. 19(2)3.

9 D. FULLERTON, *supra* note 5, at 173.

10 See Ontario Securities Act, 1978, s. 34(2)4; ALI FEDERAL SECURITIES CODE, s. 302(k).

11 Cf. *Grover & Baillie* at n. 271 and following.

12 Cf. Ontario Securities Act, 1978, s. 34(2)4 (\$50,000 figure applicable only to notes sold to individuals).

such instruments is minimal, and the Commission may deny the exemption to a corporate borrower if it is abused.¹³

Paragraphs (b) and (d) exempt instruments that are commonly used to secure loans made to finance the purchase of goods or realty. Both are usually issued in connection with face-to-face negotiations involving the transfer of title or possession of property in a commercial context that is well understood by the parties or their legal representatives and in which remedies have long been provided both at common law and by legislation. The adequacy of the protection provided to purchasers in such transactions is not an issue that should be resolved in legislation directed at public trading in securities, at least when the instruments are traded in traditional, well-defined circumstances.

However, as promissory notes and mortgages may be dealt with in a manner that requires the type of protection afforded by securities legislation, the exemptions for them in the *ALI Code* and the Ontario legislation contain conditions to ensure that they are not sold to the public as investment vehicles without some form of administrative supervision. In both cases, for example, the exemption for promissory notes is designed to permit a vendor of goods to discount notes received in payment and to permit the transfer of such notes to financial institutions but not to public investors.¹⁴ In doing so the *ALI Code* relies on the fact that a "distribution" under it does not include a limited offering, and the Ontario Act analogously uses the concept of the "public", while the new Ontario legislation, having removed the latter concept, simply precludes a sale to an individual.

None of these approaches is adopted in the Draft Act. That in the *ALI Code* is not available because of the different definition of "distribution", and that of Ontario would remove from the exemption the very transaction in which the note is created because under the Draft Act "sale" includes the issuance of a security.¹⁵ In any event, it may be insufficient to make a sale to an individual subject to the legislation and to leave exempt a sale to a one-man corporation. The Draft Act attempts to preclude a public distribution through such transactions by exempting notes *issued* in consumer transactions unless they are sold to persons other than financial institutions. Thus only the creation of the note and subsequent trades among such institutions are exempted.

A similar difficulty exists with the exemption for mortgages.

13 See PORTER REPORT at 322; and see section 3.04.

14 See ALI FEDERAL SECURITIES CODE, s. 299.53(b)(3) (mercantile paper "not involving a distribution"); Ontario Securities Act, s. 19(2)5 (precluding sales to public); Ontario Securities Act, 1978, s. 34(2)6 (precluding sales to individuals).

15 See sections 2.17, 2.40 and Commentary.

At present there is no Canadian public trading market in mortgages or other security interests¹⁶ and the provincial legislation conditions the availability of the exemption on their not being offered for sale to the public or by persons other than registered mortgage brokers. In light of the definition of "sale" in section 2.40, the issue by a mortgagor to his mortgagee would not be exempt in most cases, that is, the exemption would not exempt the most common transaction of the type to be covered. Moreover, legislation requiring registration of mortgage brokers may vary from province to province. As a result paragraph (d) exempts mortgages and similar securities and authorizes the Commission to specify the conditions necessary to protect investors. It is expected that the Commission will establish conditions that remove from the exemption only sales of mortgages to public investors where the Draft Act's protection is necessary either because of the nature of the market that develops or because no equivalent protection is available under other regulatory mechanisms.

Paragraph (c) exempts savings and similar certificates that are issued by a bank or other deposit-taking institution specified in paragraph 2.45(j). These securities are exempt from the whole of the Draft Act because, in terms of the amount of risk to investors, they are effectively equivalent to a deposit with such institutions.¹⁷ The Commission may deny the exemption if the certificates are sold in a manner that requires the application of the act's provisions.

The final paragraph of section 3.01 exempts securities of issuers with fewer than fifty securityholders. Although the exemption is analogous to that for "private companies" in the provincial acts, it is based upon slightly different considerations.¹⁸ The exemption in the provincial legislation is conditional upon there being no sale of securities to the public, presumably on the basis that such transactions are inconsistent with the usual limitations in the constating instruments of a private company as well as with the protection of investors. The exemption in paragraph (e), while complementary, is primarily premised on the view that issuers with fewer than fifty securityholders are likely to be local in relation to the securities market and do not require regulation by the federal government, even in relation to fraudulent conduct in connection with trading in securities. Thus even a distribution would not be subject to the requirements of part 5 where the issuer would have fewer than fifty securityholders after its completion.

16 Cf. *Williamson, Capital Markets*, ch. II.8.C.

17 Cf. D. FULLERTON, *supra* note 5, at 182-83.

18 See e.g. Ontario Securities Act, 1978, ss. 34(2)3, 10; cf. *Grover & Baillie* at nn. 263-65.

(In any event any such distribution is likely to be exempt from part 5, if for no other reason, because it is intraprovincial.¹⁹)

However, a reporting issuer with fewer than fifty securityholders is not included in the exemption in paragraph (e). In order to have become registered under part 4 an issuer must have had at one time over 300 equity securityholders or sufficient holders of other issued securities for an active trading market to have existed, and it is therefore likely that holders of its securities purchased in the expectation that they would receive the disclosure and other protection afforded under the Draft Act to securityholders of reporting issuers. A reporting issuer may apply to the Commission under section 4.05 to be relieved of its duties as such but the Draft Act does not permit a reporting issuer to relieve itself of such duties by reducing the number of its securityholders below fifty in order to bring itself within paragraph (e).

Section 3.02

Section 3.02 exempts from the disclosure requirements of the Draft Act securities to which parts 4 and 5 need not apply either because the nature of the issuer or of the security itself is sufficiently well understood or because similar disclosure is already required of the issuer of the securities under other legislation. Subsection (1) therefore exempts the specified securities from the requirements of part 5 and subsection (2) exempts issuers of those securities from part 4. The exemptions from the two parts are separated to make clear that issuers are exempt from registration only in respect of the specified securities but must register if a non-exempt class of securities brings them within part 4.²⁰

Although the securities listed in section 3.02 are exempt from the disclosure provisions of the Draft Act, they remain subject to its general anti-fraud provisions as well as the enforcement provisions. Thus a misrepresentation in connection with a trade in such a security is an offence that may give rise to criminal liability. However, most of the civil liability provisions in part 13 are not applicable to such securities. As no prospectus is required for their distribution, the prospectus liability provision cannot apply. Similarly, an exemption from part 4 necessarily involves exemption from part 7, which is applicable only to reporting issuers, that is, to issuers registered under the former part, so that the provisions in part 13 that impose liability for misrepresentations in documents filed with the Commission under parts 4 and 7 are also not applica-

19 See section 6.05; and *cf.* section 6.03.

20 See *e.g.* paragraph (f) and Commentary.

ble. As a result, civil liability may be incurred only where a substantive violation of the Draft Act occurs in connection with a trade in an exempt security, for example, for insider trading or deception or for prohibited transactions by a registrant. Finally, it is worth reiterating that registration under part 8 may be required of a person who carries on the business of trading in securities exempt under section 3.02.²¹

Paragraph (a) exempts debt securities issued or guaranteed by a Canadian government or municipal corporation because the terms of such securities are usually clear and the securities are, in any event, secured by the assets of the country or province and, in the case of a municipality, by the ability to levy assessments on its residents. In short, the nature of the securities is well known and they are secure. The provincial source provision for this paragraph exempt as well debt securities of any foreign country or a political subdivision of such a country. The exemption in the Draft Act does not extend to securities of foreign governments because of the wide variations in risk associated with such securities and because Canadians are not likely to be as familiar with the financial stability of foreign countries as they are with that of their own country.²²

The Draft Act exempts municipal securities which are generally sold to provincial governments or institutional investors. There is not an active trading market in them²³ and there have been no obvious abuses in Canada. The exemption has therefore been retained in substantially the form in which it has long existed in the provincial securities acts.²⁴ If any abuses occur that indicate a need for disclosure in connection with the issue of such securities, the Commission can deny the exemption under section 3.04.

Paragraph (b) derives from the provincial source provisions that exempt debt securities of the International Bank for Reconstruction and Development.²⁵ However, Canada participates in a number of international development banks and other international financial institutions²⁶ and it makes little sense to specify only one such organization in a federal act. The Draft Act therefore extends the exemption to include any international financial institution of which Canada is a member.²⁷ The condition requiring that the securities be payable in Canadian or U.S. funds,

21 See section 8.06 (exemptions from part 8).

22 See, *Grover & Baillie* at n. 255 and following.

23 See e.g. PORTER REPORT at 66.

24 Cf. *Grover & Baillie* following n. 257.

25 Cf. Bretton Woods Agreements Act, R.S.C. 1970, c. B-9.

26 See Canada, Prospectus, March 22, 1978, at 29-30.

27 Cf. ALI FEDERAL SECURITIES CODE, s. 302(c).

presumably included in the provincial acts to ensure that their value will be readily understood by Canadian investors, is retained in the Draft Act for the same reason.

Although paragraph (c) derives from the provincial source provisions, both the underlying policy and the substance of the exemption in the Draft Act go substantially further. The provincial exemption parallels that for government securities and is similarly limited to debt instruments, presumably on the basis that such securities are secure because issued by financial institutions that are generally stable and otherwise subject to regulation.²⁸ The Draft Act extends the exemption to all securities of financial institutions that are subject to the supervisory regulation of a government agency pursuant to legislation requiring disclosure to investors equivalent to that required under the Draft Act. The exemption is thus available only where the Draft Act's requirements would actually impose duplicate disclosure requirements that are unnecessary for the protection of investors and in such circumstances the agency responsible for their supervision retains primary jurisdiction in relation to disclosure as well as other regulatory matters.²⁹ However, the Commission is entitled not only to deny the exemption but also to determine whether the disclosure requirements applicable to a particular institution satisfy the standard specified in paragraph (c). This authority is expressly granted by subsection (3) and may be exercised by the Commission of its own motion or on an application by an interested person.

Although paragraph (c) is intended to include any financial institution that fulfills the conditions for the exemption as is indicated by the generality of subparagraph (c)(v), several financial institutions are specified in the preceding four subparagraphs in order to provide examples of the types of financial institution that are contemplated. Most of the institutions mentioned would not now be entitled to the exemption, even though they are subject to a regulatory scheme, as the statutes under which they are regulated do not contain disclosure requirements that meet the standard in paragraph (c).³⁰ It is hoped that the condition in the paragraph will provide an incentive to the regulators of such institutions to increase the standards for disclosure under their

28 See e.g. Ontario Securities Act, 1978, s. 34(2)1(c); and see Dey, *Exemptions under the Securities Act of Ontario*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: CORPORATE AND SECURITIES LAW 127, 163 (1972); D. JOHNSTON at 223.

29 Cf. *Grover & Baillie* following nn. 195, 258, 301; *Williamson, Financial Institutions*, ch. IV.6.

30 See, *Grover & Baillie* following n. 258.

legislation.³¹ In fact, there are indications that such a development is probable; for example, the Act to Revise the Bank Act contains disclosure requirements parallel to those under parts 4 to 7 and as a result would entitle banks subject to it to the exemption in paragraph (c).³²

Subparagraph (c)(iv) is expressly included as a result of the recommendations of the *Mutual Fund Proposals* requiring similar disclosure by mutual funds. Paragraph (c) therefore treats mutual funds like other regulated financial institutions on the assumption that the recommendations in the earlier proposals will be enacted along with any legislation based upon the Draft Act. If no exemption is available for mutual funds, the Commission could impose regulatory requirements as a condition of the exercise of its discretion to accept a prospectus under part 5, as is done at present under the provincial securities acts.³³ However, should the recommendations of the *Mutual Fund Proposals* not be enacted, it would be preferable to modify the Draft Act in order to integrate the earlier recommendations with the act's provisions as is done in the Ontario Securities Act, 1978, which contains provisions to implement the recommendations in the *Canadian Mutual Fund Report*.

Paragraph (d) exempts savings plans that are registered under the Income Tax Act and pension plans that are registered under that act or under the Pension Benefits Standards Act³⁴ or a similar provincial statute. Although it is not clear that purchasers of or contributors to such plans receive disclosure equivalent to that required in a prospectus, the instruments tend to be secure because of the institutions selling them, and there is no secondary market for them in Canada. As a result, sufficient protection in relation to them is provided by the anti-fraud provisions in parts 12 and 13. And in the event of a change in practice that necessitates greater disclosure the Commission may deny the exemption.

Not all pension plans are eligible to be registered under the Income Tax Act.³⁵ Paragraph (d) therefore includes as well pension plans, administered by a financial institution, that are registered under the Pension Benefits Standards Act or a similar provincial act which generally requires disclosure of the terms of

31 Cf. the discussion of investment contracts and annuities in section 2.45, Commentary.

32 Bill C-57, 30th Parl., 3d Sess. (First reading May 18, 1978); see especially parts IV.E, G, H and VI.

33 See e.g. National Policies 6-11, 2 CCH CAN. SEC. L. REP. ¶¶ 54-843 - 54-848.

34 R.S.C. 1970, c. P-8.

35 See Revenue Canada, Taxation, Information Circular No. 72-13R4, May 24, 1977 ("Employees' Pension Plans"); cf. Revenue Canada, Taxation, Information Circular No. 77-1R, February 13, 1978 ("Profit Sharing Plans").

a pension plan and establishes standards to ensure the safety of contributions.³⁶

Securities of nonprofit corporations such as charitable institutions, benevolent societies and social clubs have long been exempt from the disclosure requirements under the provincial securities acts and a similar exemption is included in the proposed U.S. code.³⁷ The conditions for retention of the exemption in the source provisions are strict and the approach is retained in paragraph (e) so that a general offer to the public involving a professional selling effort would preclude the use of the exemption in connection with a distribution. Such distributions are in any event likely to be limited to a single province and therefore exempt under section 6.05. In other circumstances the anti-fraud provisions and the Commission's power to deny the exemption should provide sufficient protection for investors.

Equity securities in a cooperative corporation or a credit union are held by members of the organization in order to obtain the benefits of membership in the form of a patronage dividend based upon the amount of business conducted by a cooperative or a better rate of interest on a loan from a credit union than might otherwise be obtainable. There is little if any secondary trading in such securities and the development of a trading market in them is precluded, at least in relation to cooperatives, by the fact that each member is entitled to only one vote regardless of the number of securities held by him.³⁸ As a result securities of cooperatives and shares of credit unions are exempt under the provincial securities acts, and the former type of security is also exempt under the U.S. source provision.³⁹ The exemptions in the provincial acts are limited to organizations created under acts of the same province. Paragraph (f), however, is framed in terms of the generic definitions of cooperative corporation and credit union in the Income Tax Act in order to include all such organizations in Canada regardless of minor differences between the provincial acts.

The provincial acts, while exempting only shares of credit unions, include all securities of a cooperative corporation within the exempt classifications with the result that debt securities issued by the latter type of corporation are not subject to their disclosure requirements. Debt securities, however, are not subject

36 See e.g. Pension Benefits Standards Act, ss. 9-11 ("standards for registration").

37 See e.g. Ontario Securities Act, s. 19(2)6; ALI FEDERAL SECURITIES CODE, ss. 299.9, 302(j).

38 See e.g. Co-operative Corporations Act, 1973, S.O. 1973, c. 101, ss. 1(1)5, 6; cf. *id.* ss. 40, 62 (restrictions on transfer of memberships).

39 See e.g. Ontario Securities Act, 1978, ss. 34(2)8-9, 72(1)(a); ALI FEDERAL SECURITIES CODE, s. 302(i).

to the same restrictions as equity securities in that they may be sold to the public and subsequently traded. Even though most of the provincial cooperative legislation requires some form of filing and disclosure before such securities may be distributed, the quality of the disclosure and the nature of the review of the filed documents may differ from province to province.⁴⁰ Indeed, Alberta recently amended the regulations under its Securities Act to deny the exemption for debt securities of cooperatives.⁴¹ Moreover, none of the provincial acts contains disclosure requirements like those in parts 4 and 7.

The exemption in paragraph (f) is therefore limited to equity securities of cooperative corporations as well as credit unions. It is expected that the Commission will coordinate the disclosure requirements under the Draft Act with disclosure requirements under provincial legislation relating to such organizations, and it may, where the disclosure is substantially equivalent to that required under the Draft Act, grant exemptions either generally or in specific cases.

The provincial securities acts contain a number of exemptions in relation to mining activities that are not included in the Draft Act. For example, the provisions of the new Ontario act exempt securities issued by a prospector or mining syndicate and sold by the prospector or issued and offered for sale by the syndicate.⁴² The Draft Act omits the exemptions in order to ensure that distributions of such securities that extend beyond a single province are subject to part 5 and that an issuer is subject to the continuing disclosure requirements if a trading market in its securities that is sufficiently active to cross the threshold figure in section 4.02 should develop. Sales that are genuinely entitled to an exemption under the provincial acts, that is, those involving essentially local distributions in connection with exploration for natural resources in the province, will not ordinarily be subject to the Draft Act.⁴³

The regulations under the Ontario Securities Act contain an exemption from the prospectus requirements for put and call options that are written or guaranteed by a member of a recognized exchange on which the options are traded.⁴⁴ The exemption

40 See e.g. Ontario Co-operative Corporations Act, ss. 34-37; Co-operative Associations Act, R.S.A. 1970, c. 1, s. 13; cf. Co-operative Associations Act, R.S.B.C. 1960, c. 77, s. 47 (requiring filing with supervisor where commission to be paid in connection with sale of shares).

41 See A.S.C. Summary, January 31, 1978, at 1 (Order in Council, January 24, 1978).

42 See Ontario Securities Act, 1978, ss. 34(2)11-13, 72(1)(a).

43 Cf. *Grover & Baillie* following n. 267.

44 See Ontario Securities Regulations, s. 86.

is also included in the new Ontario act.⁴⁵ Recognition of an exchange for purposes of trading in put and call options is usually conditional on the filing of a "prospectus" that describes the process of trading in the options rather than the individual options themselves.⁴⁶ The Draft Act does not incorporate a similar exemption but instead empowers the Commission to work out its own policy in relation to options trading.⁴⁷ It is expected that the Commission will then promulgate the necessary exemptions under section 3.03.

Section 3.03

The example of put and call options demonstrates the potential for the development of trading markets in securities which have not previously been actively traded, and also points to the likely development of securities of a type not now foreseen which do not necessitate all of the protection provided by the Draft Act. It is therefore necessary that the Commission be empowered to exempt such securities and section 3.03 does so.

Unlike the preceding provisions, however, section 3.03 is not limited to securities or issuers. Rather it permits the Commission to grant an exemption to any person in respect of a security or a trade from any provision of the Draft Act. The Commission's exempting power is applicable to classes of persons, securities and trades as well as to individual cases and is, therefore, exercisable either by regulation or order.⁴⁸

The breadth of the exempting power is emphasized by the fact that it would permit the Commission to grant exemptions from the anti-fraud and civil liability provisions in parts 12 and 13 as well as from the Draft Act's registration and disclosure requirements. However, an exemption from the disclosure provisions would effectively result in an exemption from some of the provisions of parts 12 and 13 in any event. Therefore, section 3.03 in result is no broader than the exempting powers in the source provisions and permits the Commission to deal directly with all cases of exemption.

It is expected, however, that the Commission will be guided in the granting of exemptions by the statement of purpose in section 1.02 and by the impact of a particular exemption on the protection of investors. The section therefore leaves the determination of the

45 See Ontario Securities Act, 1978, s. 72(1)(c).

46 See e.g. *Williamson, Capital Markets*, ch. II.8.A.

47 See, *Grover & Baillie* at n. 294; and see generally part 9.

48 See section 15.14(1)(a); cf. Interpretation Act, s. 26(7); ALI FEDERAL SECURITIES CODE, s. 303 (expressly including classes).

conditions appropriate for an exemption to be specified by the Commission in particular circumstances. And the procedural and disclosure provisions of part 15 ensure that the standards applied by the Commission will be developed in a manner that facilitates the awareness and involvement of affected persons.⁴⁹

The Commission is authorized, as well, to grant an exemption with retrospective effect. The power to make an exemption retroactive derives primarily from the Canada Business Corporations Act and is included to enable the Commission to ameliorate potentially draconian consequences resulting from an inadvertent failure to comply with a requirement of the Draft Act, for example, a takeover bid made in violation of the act because of a purchase of one share too many in the open market.⁵⁰ Again, it is expected that the Commission will exercise this power only in exceptional cases, especially as it may deprive investors of a potential cause of action. When the Commission does grant a retroactive exemption, it must, of course, do it expressly.⁵¹

Section 3.04

Section 3.04 grants correspondingly broad power to the Commission to deny exemptions. The section authorizes the Commission to deny generally (by regulation) or in a particular case (by order) any exemption under the Draft Act and thus applies to exemptions under other parts of the act as well as to those previously granted by Commission order.

The power under section 3.04 is intended to be exercised only where an exemption is susceptible of abuses or is being exploited to the potential detriment of investors. (The remedies and enforcement techniques available under parts 13 and 14 should make it unnecessary to use section 3.04 as a method of punishment.⁵²) As it may be necessary to move quickly in order to prevent investors from being harmed, subsection (2) authorizes the Commission to deny an exemption summarily. However, a summary denial is available only in particular cases and cannot be used in connection with the promulgation of regulations; for them the full procedure prescribed in part 15 is required. And where a summary order is made, the Commission must provide an opportunity for a hearing in compliance with section 15.17 within fifteen days or the order expires. Although a shorter period was considered, the Draft Act retains the fifteen-day period in the provincial legislation which is

49 See especially sections 15.15, 15.17.

50 Cf. e.g. P. ANISMAN at 57; *Anisman* at 274-75 n. 717.

51 Cf. C. ALLEN, *LAW IN THE MAKING* 463-69 (7th ed. 1964).

52 Cf. D. JOHNSTON at 363; *In re Connor*, [1976] OSC Bull. 149 (June).

long enough to permit the Commission to convene a hearing and does not appear to have resulted in injustice as administered by the provincial commissions.

Part 4

Registration of Issuers

Since its statutory introduction in the United Kingdom in 1844, disclosure by issuers of securities has been increasingly accepted in the English-speaking world as a basic method of preventing fraud in connection with the sale of and trading in securities.¹ In fact, disclosure by securities issuers of information material to the value of their securities is now generally acknowledged as necessary to enable investors to make rational investment decisions and to enable securityholders to exercise their rights as such on an informed basis.² The latter function is usually accomplished by means of the proxy process and the former by means of statutory provisions requiring regular and timely disclosure of corporate developments so that investors may have equal access to information affecting the value of their securities.³

The specific purposes of disclosure by issuers, deterrence of fraudulent trading and the enhancement of investor decision-making, are intermediate; their general purpose is to increase investor confidence in the securities market by ensuring and facilitating its fair operation and thus, ultimately, to increase the depth of the trading market and the allocational efficiency of the primary markets. Put simply, people will more readily invest in securities when the market operates fairly and efficiently, and

1 See e.g. BUSINESS CORPORATIONS PROPOSALS, ¶ 256.

2 See e.g. *Grover & Baillie* at nn. 159-60.

3 See e.g. parts 7A, 7B.

disclosure in relation to new issues will enable a rational selection of investment vehicles. Despite some arguments to the contrary, the preponderance of evidence appears to favour the statutory imposition of disclosure requirements administered by a government agency as the best method of accomplishing these ends.⁴

Even if mandatory disclosure by issuers is justifiable on an economic as well as an equitable basis, it is still desirable to reduce as much as possible the costs of disclosure to issuers without unduly diminishing the availability of necessary information to investors. While the Joint-Stock Companies Act of 1844 required an annual report to shareholders,⁵ the emphasis in the United Kingdom in relation to disclosure for the protection of investors was on disclosure in connection with the raising of capital, in particular, on the use of a prospectus for new issues of securities.⁶ Developments in North America have tended to follow a similar pattern. In the 1890s the New York Stock Exchange imposed a duty on listed issuers to file an annual report,⁷ but the securities legislation enacted by the states and the Canadian provinces dealt only with the issue of securities (and the registration of brokers and dealers). The United States Congress also dealt first with disclosure in relation to distributions in the Securities Act of 1933. Within a year, however, Congress turned its attention to the secondary markets and imposed in the Securities Exchange Act of 1934 a duty on corporations with securities listed for trading on a national securities exchange to disclose regularly information relating to their business and affairs.

The potential for coordination of the disclosure requirements under the two acts relating to new issues and corporate performance was noted almost immediately but the subject was largely ignored during the succeeding three decades.⁸ It was resurrected in 1964 after Congress extended the application of the 1934 Act to all substantial issuers whose securities are widely held regardless of whether they are traded on an exchange or in the over-the-counter market.⁹ And a substantial impetus was given to discus-

4 See e.g. Mendelson, *Economics and the Assessment of Disclosure Requirements*, 1 J. COMP. L. AND SEC. REG. 49 (1978); REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SEC I-XLIX (1977).

5 See, *Grover & Baillie* at n. 42 and following.

6 See e.g. B. HUNT, *THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867*, 94-95 (1936); 1 L. LOSS at 5-7.

7 See e.g. R. SOBEL, *THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET* 132, 177-78 (1965).

8 See Kearns, *Coordination of Securities Acts*, 31 ILL. L. REV. 718 (1937).

9 See Securities Exchange Act of 1934, s. 12(g); see also KNAUSS, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964); Heller, "Integration" of the Dissemination of Information under the Securities Act of 1933 and the Securities Exchange Act of 1934, 29 L. & CONTEMP. PROBS. 749 (1964).

sion of coordination of the disclosure requirements under the two acts by Milton Cohen, the director of the SEC Special Study of Securities Markets, in an article published in 1966 that has played a seminal role in subsequent developments.¹⁰ The article led to the appointment of the committee of the Securities and Exchange Commission that published the *Wheat Report* advocating that the Commission, through its power to make rules, itself coordinate the disclosure requirements of the 1933 and 1934 Acts in order to avoid unnecessary duplication and complicated technical requirements. The Commission implemented most of the report's recommendations. And it has recently received a further report from an advisory committee appointed by it to reconsider disclosure by issuers and has indicated that it is on the whole receptive to the committee's recommendations.¹¹

Canadian securities legislation has followed the same general path. Both corporate and securities legislation initially focused on new issues and prospectus disclosure.¹² The *Porter Report*¹³ in 1964 emphasized the need to follow the U.S. example and extend disclosure requirements beyond distributions in order to protect investors adequately, and the *Kimber Report* a year later provided a detailed basis for doing so. By 1969 the recommendations of the latter report were substantially implemented not only in Ontario but also in the four provinces west of it; and in 1973 the Quebec Securities Act too was amended to include requirements for regular financial disclosure by public issuers, disclosure in connection with takeover bids and the solicitation of proxies and reporting by insiders of transactions in the securities of their issuers.¹⁴ The *Ontario Securities Commission Disclosure Report* was, as a result, able to build upon this foundation in recommending the adoption of a system of continuous disclosure, similar to that advocated in the *Wheat Report*, in which the requirements relating to new issues, the trading market and shareholder decision-making would form an integrated whole. Its recommendations were translated into statutory form in Ontario Bill 154 and with some modifications have formed the basis for the disclosure provisions of the subsequent Ontario bills, including the Ontario Securities Act, 1978.

The Draft Act, in adopting a system of continuous disclosure, follows the modern trend. Issuers, that as a result of a distribution

10 See Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966).

11 See REPORT OF THE ADVISORY COMMITTEE ON DISCLOSURE TO THE SEC; SEC, Securities Act of 1933 Release No. 5906, February 15, 1978, 14 SEC Docket 140.

12 See e.g. J. WILLIAMSON, ch. 1; *Grover & Baillie*, chs. II.5, 6.

13 At 350-52.

14 See e.g. P. ANISMAN, ch. 1; and see, *Grover & Baillie*, ch. V.

or otherwise have sufficient public holders of their securities to permit active trading, must register under this Part. Such registration entails the filing of a registration statement that sets out specified information relating to the issuer and imposes, as well, a duty to provide regular and timely information to shareholders pursuant to part 7. And issuers that make a distribution, whether they are registered or not, must comply with the disclosure and other prospectus requirements of part 5. Thus, while all issuers that distribute their securities must file a prospectus, those whose shares are widely held must also provide on a continuing basis information concerning their activities.

The purpose of the disclosure requirements in parts 4 and 7 is to ensure that public securityholders of an issuer and their advisers may obtain current material information concerning it so that they may make rational investment decisions. The requirements of the two Parts are, however, not coextensive. The information sent to shareholders under part 7 is expected to be presented in a form that will be readily understandable by lay investors and will frequently describe specific events or be directed at particular decisions. The obvious examples are press releases concerning material developments and proxy circulars. Similarly, annual and quarterly reports to securityholders and in some cases even prospectuses are not likely to go into great detail but rather to present a descriptive report of current developments in a manner that is readily understandable.

The information contained in a registration statement under this Part, on the other hand, is intended to be far more detailed and may include "soft data" such as earnings projections. This material, which must be updated annually, will provide the basis of the Commission's file on each "reporting issuer". Integration of the specific disclosure requirements in the various documents to be filed under parts 4 and 7 is left to the Commission.¹⁵ In result, the scheme of the Draft Act is expected to provide a comprehensive source of issuer information on file with the Commission and clearer, more concise and more readable documents being sent to investors.

Compliance with the disclosure requirements of the Draft Act will be no more onerous than the present reporting responsibilities of public issuers. If anything it will reduce their burden, for reporting issuer status under part 4 carries with it a number of benefits. As disclosure under parts 4 and 7 ensures the availability of substantial information about reporting issuers on a continuous basis, the need of investors for detailed disclosure in special cir-

15 See, *Grover & Baillie* following n. 306.

cumstances such as distributions will be concomitantly reduced so that the prospectus requirements applicable to such issuers under part 5 will be lessened. In other words, it is expected that the Commission will take the continuous disclosure made by reporting issuers into account when prescribing the contents of prospectuses issued by them.¹⁶ Similarly, because up-to-date information concerning them is continuously available to the public and to investment analysts, reporting issuers are entitled to the trading transaction exemption in section 6.04 and may therefore sell small amounts of securities through registrants without having to file a prospectus.

Registration under part 4 may also provide further benefits. As the registration statement filed with the Commission may contain information not directly related to the needs of investors,¹⁷ the Commission's files may come to serve as a repository of information on reporting issuers available not only to investors but also to other government agencies and thus may ultimately serve to reduce their obligation to disclose particular items to other bodies. The Commission's files may also in time perform the functions of a "business register" for reporting issuers and in effect decrease the costs attributable to reporting information to public bodies.¹⁸ At the very least the file should serve as a central data base for all Canadian securities administrators and probably for foreign authorities as well.¹⁹

Some consideration was given to requiring reporting issuers to list their securities for trading on a stock exchange. Such a requirement would facilitate the dissemination of information concerning trading in such securities and would make it subject to the surveillance normally conducted by the exchanges and thus enhance the Commission's ability to supervise the trading market generally. In addition, the fact that the securities of all reporting issuers would be traded in an organized market would likely increase investor confidence and enable small issuers to obtain capital more easily.²⁰ These were some of the reasons leading to the adoption of a similar policy by the Quebec Securities Commission.²¹ And the movement in the United States toward a national trading system that includes securities listed on NASDAQ will ac-

16 See e.g. Grienemberger and Ashford, *Differential Disclosure*, 11 REV. SEC. REG. 919 (May 17, 1978).

17 See, *Grover & Baillie*, ch. III.A.

18 See generally, *Hall*.

19 See generally, *Hebenton & Gibson*.

20 See, *Williamson*, *Financial Institutions*, ch. V.6.

21 See Quebec Policy No. 3, 3 CCH CAN. SEC. L. REP. ¶ 66-014; see also, *In re Nu-West Development Corporation Ltd.*, 9 QSC Bull., No. 24 (Decision 5588, June 20, 1978) (granting exemption from policy).

comply with a similar result. Moreover, such a requirement would ensure federal jurisdiction over such trading without the uncertainties that accompany reliance on the ancillary doctrine.²²

Nevertheless, it was concluded that a mandatory listing requirement might be premature in Canada, at least until there has been greater experience with automated trading systems.²³ Some concern was expressed, as well, over the fact that such a requirement would deprive the exchanges of their strongest sanction against listed companies, that is, delisting.²⁴ And the fact that an over-the-counter market is viewed as a desirable development in the United Kingdom where all equity securities were traditionally traded on The Stock Exchange gave further reason for pause.²⁵ As a result the Draft Act does not include such a requirement.

The question of mandatory listing is, however, still worthy of serious attention and should be considered in light of the Draft Act and the development of the Canadian securities market. Should these *Proposals* be accepted and the Draft Act translated into a bill, the issue will require determination. This is another matter, therefore, upon which comments from knowledgeable persons would be of substantial assistance.

Section 4.01

Issuers are required to register under part 4 when their securities are sufficiently widely held that an active public trading market in them may exist. The registration requirement is contingent upon the number of independent holders of an issuer's securities. Paragraph 4.01(b) therefore defines as public securityholders all persons who hold securities of an issuer other than insiders of the issuer and their associates.²⁶ The "insiders" are specified in subparagraphs (b)(i) to (iii). While a cross reference to one of the definitions of insider contained elsewhere in the Draft Act might at first seem simpler, those definitions are inappropriate. That in section 7.11, which applies to insider reporting, is too narrow because it is limited to reporting issuers; and that in section 12.02 is directed at the misuse of confidential information and as a result is too wide. For the same reasons a definition of "insider" for purposes of the whole act was not feasible.

Some question may be raised about the exclusion of employees

22 See, *Anisman & Hogg* following n. 201.

23 See e.g. *Grover & Baillie* at n. 313.

24 See *id.* n. 314.

25 See *id.* following n. 314; see Wilkins, *Talks on Supervisory Body for OTC Market*, *The Times*, April 17, 1978, at 19, col. 3.

26 See, *Grover & Baillie* following n. 312.

as “public securityholders”, especially as a substantial number of non-managerial employee securityholders may lead to the development of a market in the security. Employees were excluded from the definition to avoid counting security holdings that derive largely from incentive plans adopted by their employer and thus to avoid a requirement that might deter the creation or continuation of such plans. Nevertheless, if an active market does develop in the securities, employees too should be entitled to information concerning the issuer. The Commission is therefore empowered to require registration in such circumstances.²⁷

As registration under part 4 is directed primarily at protection of Canadian investors, the definition of public securityholder is limited to a person resident in Canada holding at least one board lot of the issuer’s equity securities. A “board lot” is the basic trading unit of securities on the Canadian stock exchanges and is, therefore, an appropriate standard for purposes of determining when a trading market is possible. As the exchanges themselves are in the best position to determine the size of such units, paragraph (a) defines “board lot” in terms of the by-laws of a registered stock exchange. The relevant provisions of the three major Canadian exchanges are now substantially uniform.²⁸ And the Commission is authorized under part 9 to require that they be made uniform or otherwise altered, should it become necessary to do so.²⁹

Section 4.02

Section 4.02 establishes the standard for the attainment of reporting issuer status. An issuer must file a registration statement under the section if it has a class of security listed on a registered securities exchange or if it has 300 public holders of its equity securities. And an issuer may apply to the Commission for permission to file even if it does not meet these criteria.³⁰ Once it has filed a statement it becomes a “reporting issuer” subject to the continuous disclosure requirements of part 7.³¹

As the duties imposed upon and the benefits available to a reporting issuer under the Draft Act relate to the potential for an active public market in its securities, the registration requirement

27 See section 4.03 and Commentary.

28 See Montreal Stock Exchange Rules, s. 6102, 3 CCH CAN. SEC. L. REP. ¶ 86-016; Toronto Stock Exchange By-Laws, s. 11.14, 3 CCH CAN. SEC. L. REP. ¶ 89-404; Vancouver Stock Exchange Rule 372, 3 CCH CAN. SEC. L. REP. ¶ 94-162.

29 See section 9.07 (Commission alteration of by-laws of registered exchange).

30 See subsection (3).

31 See section 2.38.

is triggered when an issuer's securities are held by 300 persons who are independent of it.³² The numerical standard reflects this market orientation, for it has generally been concluded that 300 securityholders are necessary before an active public market can exist.³³ For similar reasons the listing requirements of the Toronto Stock Exchange require that an issuer have at least 300 public shareholders.³⁴ And the *ALI Federal Securities Code* initially specified the same number but reverted to the figure of 500 in the Securities Exchange Act of 1934.³⁵

However, as not all securities exchanges in Canada impose the same listing requirements, the 300 figure alone might exclude a number of issuers with securities listed and traded on a registered exchange that are subject to continuous disclosure obligations under exchange rules.³⁶ The Draft Act therefore imposes an obligation to file a registration statement on all issuers with a class of securities listed on a registered securities exchange. And to prevent the development of any gaps in the act's coverage, the Commission is also given power to require other issuers to file.³⁷

The registration requirement under the *ALI Federal Securities Code* is based on a dual standard; not only must an issuer have the specified number of securityholders but it must also meet an asset test.³⁸ And a similar condition is included in the listing standards of some Canadian stock exchanges. Although most issuers with 300 shareholders would meet the asset test in the *ALI Code*, there are a number of mining corporations in Canada which would not do so, but the securities of which are nevertheless widely traded.³⁹ The asset test thus has little to do with the trading activity in an issuer's securities,⁴⁰ but is rather related to the issuer's ability to bear the costs of compliance with the disclosure provisions of the legislation. The Draft Act therefore requires registration only on the basis of shareholdings and permits an issuer to apply to the Commission for an exemption if it faces peculiar difficulties as a result of the act's requirements.⁴¹

The registration provisions under section 4.02 are not triggered by the filing of a prospectus under part 5, as is the case under

32 Cf. paragraph 4.01(b) and Commentary.

33 See e.g. 3 SPECIAL STUDY REPORT at 61-62.

34 See TSE Policies, ss. 7.03, 7.11, 7.19, 3 CCH CAN. SEC. L. REP. ¶¶ 92-040, 92-048, 92-056.

35 See ALI FEDERAL SECURITIES CODE, s. 402; Securities Exchange Act of 1934, s. 12 (g).

36 See e.g. Montreal Stock Exchange Rules, s. 9053, 3 CCH CAN. SEC. L. REP. ¶ 86-805 (200 public securityholders).

37 See section 4.03 and Commentary.

38 See ALI FEDERAL SECURITIES CODE, s. 402 (\$1 million).

39 See, *Grover & Baillie* following n. 314.

40 See 3 SPECIAL STUDY REPORT at 62.

41 See section 3.03.

the *ALI Federal Securities Code* and the new Ontario act.⁴² Under the Draft Act a prospectus may be required in connection with a distribution to fewer than 300 purchasers and indeed to fewer than 50.⁴³ The major reasons for requiring a registration statement in such circumstances are the ease of doing so and the cost savings when a prospectus containing most of the required information must be prepared in any event. The emphasis in the Draft Act, however, is on the likelihood that an active trading market will develop and that security analysts will follow the security and thus disseminate the information contained in the issuer's file. Both of these developments may not occur in all cases where a prospectus must be filed. The Draft Act therefore requires compliance with section 4.02 only where a distribution is wide enough to meet the specified standard. Because registration follows the issuer's fiscal year end, the costs associated with it are not likely to be high. And if an issuer wishes to obtain "reporting" status when it makes its initial distribution, it may apply to the Commission pursuant to subsection (3), and the Commission may impose any conditions necessary to ensure the achievement of the Draft Act's purposes.

An issuer that does not meet the standards in subsection (1) may wish to become registered in order to obtain the benefits of the trading transaction exemption and to permit its insiders to trade without having to file a prospectus.⁴⁴ As such an issuer will neither have its securities listed nor have 300 securityholders, it is not entitled to registration as of right; rather the Commission may permit registration on a case-by-case basis with a view to ensuring that the trading market in the issuer's securities is sufficient to warrant its obtaining the above benefits (subsection (3)). The Commission may grant such an application, for example, where the issuer's securities are held by more than 300 persons but fewer than that number own board lots. However, as the variety of circumstances surrounding such applications cannot be foreseen, the Commission is authorized to impose conditions that it thinks necessary to ensure that the protection afforded to investors under the Draft Act will not be undermined.⁴⁵ The Commission may accomplish the same goal with issuers that come within subsection (1) by denying the exemptions in part 6.⁴⁶

42 See *ALI FEDERAL SECURITIES CODE*, s. 403; *Ontario Securities Act*, 1978, s. 1(1)38 ("reporting issuer").

43 See e.g. section 6.02(2) and Commentary; cf. paragraph 3.01(e) and Commentary.

44 See e.g. paragraph 2.17(b) ("distribution").

45 See, *Grover & Baillie* following n. 314.

46 See section 3.04 and Commentary.

Section 4.03

Only issuers with over 300 equity securityholders, each holding at least a board lot and each resident in Canada, are required to file a registration statement under section 4.02.⁴⁷ As a result a number of situations may arise where the securities of an issuer are actively traded and there is no obligation to file a registration statement. For example, an active market in debt securities may warrant the disclosure that would be provided for a similar market in equities.⁴⁸ Equally likely, an active market in an issuer's equity securities may exist as a result of the securities being held by over 300 persons, although less than that number hold a board lot or reside in Canada. In the latter case the Commission may wish to ensure that a Canadian issuer does not sell its securities abroad and thus create an active offshore market in them without providing adequate disclosure.⁴⁹

Section 4.04

The registration statement required under this Part is intended to provide the basis for a complete current overview of information relating to the issuer. Section 4.04 furthers this result by requiring that the information be updated annually and by expressly encouraging issuers to include all information that they believe may be useful to investors. As indicated above, the registration statement is expected to be utilized primarily by investment analysts and sophisticated investors and should, therefore, include "soft data" such as earnings forecasts and plans for future development as well as the "hard" information contained, for example, in financial statements. The registration statement is therefore not required to be sent to shareholders but will be available from the Commission, presumably in microfiche or a similar form, so that those who are interested in it may obtain copies easily.⁵⁰ And in time it may form the basis of a central, continuously updated, computerized data base on public issuers that may be utilized by government agencies as well as by the public.⁵¹

Although the reports sent to securityholders under part 7 are expected to be less detailed and technical than the registration statement and thus more easily understandable by lay investors,

47 See paragraph 4.01(b).

48 See, *Grover & Baillie* following n. 312.

49 See e.g. *Anisman & Hogg* at nn. 17-19.

50 See, *Grover & Baillie*, ch. VI.2.b.

51 See generally, *Hall*.

it is likely that the Commission will wish to coordinate the disclosure requirements under parts 4 and 7 in order to increase the utility of both types of document and to avoid unnecessary duplication. Subsection (2) emphasizes this thrust by imposing a time period for amendment of the registration statement that coincides with the time period for the circulation of annual reports by reporting issuers.⁵² Both are likely to be prepared simultaneously in any event.

The dual information concept in the Draft Act is somewhat different from current requirements. However, it appears to represent a direction for disclosure by public issuers that is consistent with the realities of investment decision-making and ensures that holders of securities that are not closely followed by investment analysts may obtain sufficient information to make their investment decisions. Efforts in this direction are likely to minimize costs and at the same time provide easier access to a larger pool of information for all.⁵³

Section 4.05

As registration of issuers under part 4 is premised upon the existence of an active trading market in the issuer's securities, some mechanism is necessary to permit a reporting issuer to escape its obligations under the Draft Act once a market in its securities ceases to exist and to enable the Commission to deprive it of the benefits of its status in such circumstances. Section 4.05 provides the means to accomplish both these ends where the number of public equity securityholders of a reporting issuer falls below 100.⁵⁴

This quantitative standard serves as a rule of thumb to indicate the likelihood that active trading in the issuer's securities has ceased. The standard of the Draft Act represents a compromise between the market orientation of part 4 and the concept of investor protection in the provincial securities laws and the Canada Business Corporations Act, which require a determination that no securityholder would be prejudiced, and in the Ontario Business Corporations Act, which requires that there be fewer than fifteen securityholders.⁵⁵

A number of matters relating to section 4.05 merit emphasis.

52 See section 7.01(1).

53 See Kripke, *Where Are We on Securities Disclosure After the Advisory Committee Report?* 6 SEC. REG. L.J. 99, 116 (1978).

54 See, *Grover & Baillie* at nn. 315-16.

55 See e.g. Ontario Securities Act, s. 104(3); Canada Business Corporations Act, s. 2 (8); Ontario Business Corporations Act, s. 1(9).

The 100 figure merely provides a cutoff point that enables the initiation of a proceeding by the Commission, the issuer or a securityholder. The Commission is not obliged to make an order and is, in fact, expected to take into account the equities of the particular case and to apply the standards specified in section 4.03.

On the other hand, unless an issuer's equity ownership is reduced below the specified number, the Commission has no jurisdiction to deprive it of reporting issuer status. It may, however, prevent an issuer from abusing its position by denying it the use of the exemptions in part 6 of the act and by requiring disclosure of any deficiencies in the issuer's conduct in any prospectus that it issues. Finally, even an issuer that is the subject of an order under section 4.05 remains subject to the anti-fraud provisions of the Draft Act until its total number of securityholders falls below fifty.⁵⁶

Thus the pattern of the Draft Act in this context is as follows. An issuer with fewer than 50 securityholders is not subject to any provision of the act other than section 3.04 and part 14. Once the number exceeds 50, it is subject to the general anti-fraud provisions as well. Where an issuer has over 300 securityholders, the Commission may require it to file a registration statement if it meets the standards specified in section 4.03. And where the issuer has over 300 public securityholders as defined in section 4.01, it must file a statement under section 4.02. The filing of a registration statement confers reporting issuer status, which can be lost only by a declaration of the Commission under section 4.05.⁵⁷ Such an order may be obtained from the Commission once the issuer's public securityholders number less than 100, that is, when an active trading market in its securities is no longer likely. But the issuer will remain a reporting issuer even if it reduces the number of its securityholders below 50 until the Commission makes such a declaration. By means of this scheme the Draft Act ensures that issuers will not be subjected to the costs of compliance until a public interest in the protection of investors arises. But when such an interest does arise it is paramount, and the issuer cannot divest itself of the duties so acquired without subjecting itself to the scrutiny of the Commission so that investors may be assured of fair treatment.⁵⁸

56 See paragraph 3.01(e); and see parts 12, 13.

57 See section 2.38.

58 See section 2.38 and paragraph 3.01(e) and Commentary.

Part 5

Distributions

Presumably because distributions of securities were often accompanied by extraordinary promotional efforts, the early legislation focused on them and required the filing of a prospectus with a public authority whose duty was to qualify them with respect to accuracy and completeness of disclosure and with respect to the merits of the enterprise being promoted.¹ The U.S. Securities Act of 1933 stands alone, for it requires only disclosure and does not give a “blue sky” discretion to the Securities and Exchange Commission. But the Canadian statutes are in the mainstream in this regard; they contain detailed disclosure requirements and also grant a discretionary power to the commissions to refuse a receipt for a prospectus where the securities offered by it are not worthy of investors’ attention because they involve a degree of risk that is inherently unfair.² Indeed, even though the benefits of merit regulation of new issues have been questioned,³ it has frequently been said that the 1933 Act in the United States could rely exclusively on the disclosure technique only because of the backstop provided by the “fair, just and equitable” standard in the state acts.⁴ Recent assessments have confirmed the utility of

1 See generally, L. LOSS & E. COWETT, *BLUE SKY LAW* 17-42; and see Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 L. & CONTEMP. PROBS. 193, 207-30 (1958); Grover & Baillie, chs. III-IV.

2 See e.g. Ontario Securities Act, s. 61; Ontario Securities Act, 1978, s. 60.

3 See, Williamson, *Capital Markets* at nn. 110-12.

4 See e.g. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1603, Comments 2(a), (5); and see, Grover & Baillie at n. 303.

disclosure requirements in connection with new issues.⁵ Even in a continuous disclosure system a prospectus is necessary, for a distribution constitutes a special event in terms of both the issuer and the market for its securities in that it ordinarily involves a sales effort and consequent pressures on investors to purchase the securities offered.

Part 5 of the Draft Act establishes the administrative and disclosure requirements for distributions. The Draft Act retains prospectus requirements parallel to those in the provincial statutes including a blue sky discretion in the Commission. At the same time, however, it attempts where possible to reduce the burden on issuers making a distribution by encouraging the Commission to coordinate the disclosure requirements for reporting issuers that are required to make substantial information available to investors on a continuous basis. The Commission is thus likely to develop different types of "short form" prospectus for new issues by seasoned issuers, varying according to the stability of the issuer and the nature of the security being distributed.⁶

Distributions by blue chip issuers are facilitated in other ways as well. The "uniform" provincial securities acts, other than British Columbia's, require the filing of a preliminary prospectus, omitting information concerning the price and number of securities to be issued, and a "waiting period" from the time of filing until a receipt for the final prospectus is issued.⁷ During the waiting period an underwriter may solicit indications of interest by means of the preliminary prospectus; but if a material adverse change occurs, an amendment to the prospectus must be filed with the commission and sent to every person who received a copy of it. As a result, the preliminary prospectus is not commonly used for this purpose; rather the underwriter waits until a receipt for the final prospectus is issued before soliciting purchasers. Perhaps to encourage greater use of preliminary prospectuses, the Ontario Securities Act, 1978, has removed the provision requiring amendment of a preliminary prospectus, even though it retains the duty to keep a list of the persons to whom the prospectus is sent.⁸

The Draft Act permits a seasoned issue to come to the market more quickly than at present by removing the mandatory waiting

5 See e.g. Williamson, *Capital Markets*, ch. II.5.A.ii; Mendelson, *Economics and the Assessment of Disclosure Requirements*, 1 J. COMP. CORP. L. & SEC. REG. 49, 58-59 (1978).

6 See e.g. Grover & Baillie at nn. 146-57, 350-53; Grienberger and Ashford, *Differential Disclosure*, 9 REV. SEC. REG. 919 (May 17, 1978).

7 See e.g. Ontario Securities Act, ss. 35-40; cf. British Columbia Securities Act, ss. 37-38; and see Ontario Securities Act, 1978, ss. 64-67.

8 Ontario Securities Act, 1978, ss. 66-67.

period and the requirement of a preliminary prospectus.⁹ Since review of a relatively short prospectus filed by a reporting issuer whose files are current may be performed quickly by the Commission's staff, such issues may be brought to the market within a few days of filing. In fact the Commission is expected to require its staff to facilitate the clearance of such distributions. Moreover, during the de facto waiting period between the time of filing and clearance, the Draft Act permits an issuer or underwriter to distribute advertising materials that meet standards established by the Commission.¹⁰

Because less information is available concerning their securities and greater risk associated with them, a similar procedure cannot as easily be provided for small businesses. However, it is desirable that the securities market be more accessible to such issuers as a source of capital, and the Securities and Exchange Commission has initiated proceedings to determine whether there are methods of making it so.¹¹ It is expected that the Canadian Securities Commission will avail itself of the results of the U.S. proceedings and that it too will seek methods of enabling small businesses to obtain capital without undue expense in a manner consistent with the protection of investors.¹²

The Draft Act extends the concept of prospectus disclosure in one major area. It is clear from the definition in section 2.17 that a "distribution" includes the sale of a substantial block of securities that are held by a person who neither controls nor exercises a determinative influence over the issuer's policies. The explanation for this innovation, discussed in the commentary to section 2.17, demonstrates that the Commission must devise for such distributions a specially tailored disclosure document which contains information needed by public investors during the distribution but which differs substantially from a traditional prospectus because of the independence of the issuer and the selling securityholder. In order to emphasize the different nature of this type of document, part 5 adopts the concept of a "block distribution circular".¹³

The clearing of prospectuses for interprovincial issues of securities necessarily involves the coordination of the various regulatory schemes applicable to them as is demonstrated by the cooperative efforts of the provincial commissions.¹⁴ Any federal legis-

9 See, *Grover & Baillie* at n. 347 and following.

10 See section 5.03.

11 See, *Williamson, Capital Markets* at nn. 85-86.

12 See e.g. *Grover & Baillie* at n. 352 and following.

13 See section 5.01 and Commentary.

14 See e.g. *Anisman & Hogg*, n. 8 and accompanying text; Lockwood, *Procedures in Cross-Country Prospectus Clearance and Regulation by Policy Statement*, in *LAW*

lation applicable to new issues must also provide a means to avoid the imposition of unnecessary costs or redundant requirements.¹⁵ The Draft Act attempts to accomplish this goal by facilitating the coordination of its requirements with the provincial ones by means of cooperation between the Canadian and provincial commissions.¹⁶

Part 5 complements this approach by requiring the federal commission to permit the sale of securities in any province in which the local commission clears them for sale (section 5.10). This provision, along with the exemption for intraprovincial distributions in section 6.05, ensures that the degree of blue sky protection accorded local investors may be determined by the provincial legislatures and their delegates even in respect of national distributions. In short, any province may establish the standards that apply to the sale of securities to its citizens, presumably to promote its own industrial or natural resource policies, regardless of whether the securities meet the requirements of the Draft Act.¹⁷

Part 5 includes as well a number of minor changes relating to the distribution process, for example, a lengthier prospectus delivery period (section 5.04) and a potentially shorter life for a prospectus (section 5.08). It continues, however, the possibility of a distribution being made through the facilities of a securities exchange (section 5.14). Although such distributions have in the past been the subject of criticism, they have apparently served a useful function for smaller issuers and, as all listed issuers must register under part 4 in any event, the Draft Act continues to permit them.¹⁸

Section 5.01: "Block Distribution Circular"

As mentioned above, the definition of "distribution" includes the sale of large blocks of securities by sophisticated investors who are not in control of the issuer. Such transactions are included as "distributions" so that an investor may receive information necessary to his trading decision whenever a block of securities that is large enough to affect the price of the security and thus requires some market grooming is sold into the market.¹⁹ The Commission is therefore empowered to specify the disclosure required for such

SOCIETY OF UPPER CANADA, SPECIAL LECTURES: CORPORATE AND SECURITIES LAW 111 (1972).

15 See e.g. *Grover & Baillie*, ch. I and at nn. 302-03.

16 See e.g. sections 15.06, 15.07 and Commentary.

17 See section 5.10, Commentary.

18 See, *Grover & Baillie* at nn. 196, 295-98, 412-15; and see section 5.14 and Commentary.

19 See section 2.17, Commentary.

sales regardless of whether the seller is a control person or an institutional investor. The sale of securities by an outsider, even a large one requiring a special sales effort, does not have the same significance for investors as one by a controlling securityholder and may not necessitate disclosure of the same type or amount of information. Indeed, it is necessary to weigh carefully the possibility of undesirable consequences resulting from similar treatment of the two types of transaction.²⁰

By introducing the concept of a “block distribution circular” the Draft Act emphasizes the different nature of the disclosure document required in connection with a distribution by a non-controlling person, identifies and isolates the treatment of such distributions, and thus facilitates analysis of the consequences of extending the meaning of the defined term “distribution”. Should the concept be adopted and prove workable, it may be desirable to extend its application to the more traditional type of secondary distribution.²¹

Section 5.02

Despite its apparent simplicity, section 5.02, which stipulates the disclosure required in connection with a distribution of securities, is a cornerstone provision of this Part. In short, the section requires that a prospectus or block distribution circular be filed and accepted by the Commission before any person may distribute a security. The Draft Act empowers the Commission to prescribe the contents of both types of offering circular (section 5.05) and requires dissemination to purchasers under sections 5.04 and 5.15.

It is worth emphasizing that the prohibition in section 5.02 is not limited to the issuer. It applies to a person, such as an underwriter or other registrant, who acts in furtherance of a distribution. The breadth of the provision results from the definition of “distribution” in section 2.17. As “distribution” is defined in terms of “sales” of securities, any person who acts in furtherance of the sale of a security in the specified circumstances is engaging in a distribution.²² Although a broad prohibition is necessary to make the prospectus requirements effective, unnecessarily harsh consequences are avoided by the fact that a criminal offence occurs only if the person trading knows that he is engaging in a

²⁰ See section 2.17, Commentary.

²¹ See paragraph 2.17(c).

²² See sections 2.17, 2.40.

distribution and by the specificity of the provision creating civil liability for a violation.²³

Section 5.03

Section 5.03 deals with sales efforts both before and after the Commission issues a final receipt. Once the Commission accepts a prospectus, an offer of a security must be made by the prospectus itself, a summary prospectus, or a communication that fulfills the requirement of paragraph (1)(d). The most common type of communication other than a prospectus is likely to be a "tombstone advertisement" that contains only the information specified in the paragraph, namely, the issuer and price of the security and the name of a person through whom it may be purchased. However, other types of communications are permitted²⁴ so long as they meet whatever further disclosure requirements the Commission considers necessary.

The application of the provision is not, however, limited to solicitations after the prospectus is cleared. Before a prospectus is accepted, prospective purchasers may be sought by means of a preliminary prospectus or an advertisement within paragraph (1)(d) that indicates how such a prospectus may be obtained. In short, an issuer who wishes to solicit purchases of his securities while his prospectus is being vetted by the Commission may use a preliminary prospectus;²⁵ but there is no mandatory waiting period and no need to retain a list of persons to whom the prospectus is sent.²⁶ Moreover, a tombstone or equivalent advertisement may be used during this period, thus extending the type of solicitation permissible prior to approval by the Commission.²⁷

Registrants are permitted substantial flexibility to obtain indications of interest in a forthcoming distribution from their clients provided that they first notify the Commission of their intention to do so.²⁸ The provision is less strict than the provincial models which require a registrant to send a preliminary prospectus to persons solicited.²⁹ But the required notification will permit the Commission to monitor a registrant's promotional activities and thus will serve as a deterrent to abuse of the privilege granted under the section.

23 See sections 13.05, 14.10.

24 See section 2.01 ("advertisement").

25 Cf. *Grover & Baillie* at nn. 215-19.

26 See *id.* at n. 221 and following.

27 See *id.* at n. 222 and following.

28 See subsection (2).

29 See e.g. Ontario Securities Act, 1978, s. 64(2)(c).

"Offer to sell" is defined in subsection (3) in order to extend its ordinary meaning to include attempts to sell and invitations to make an offer to purchase. It is framed in terms of a "disposition" rather than a "sale" to avoid the undue breadth of the term that would result from the fact that a "sale" includes all efforts made in furtherance of a disposition.³⁰

Similarly, because of the breadth of the meaning of "sale", a distribution includes any sales efforts made prior to the acceptance by the Commission of the prospectus relating to it. The reference in subparagraph (d)(i) to a security that is distributed is therefore sufficient to cover advertisements both before and after a prospectus is accepted.

Section 5.04

Section 5.04 rounds out the disclosure scheme of part 4 by requiring that a prospectus or block distribution circular be sent to every purchaser of a security being distributed or to his agent. The provision goes further than the existing Canadian legislation by specifying a precise period of time, ninety days after a receipt for the prospectus is issued by the Commission, during which the duty continues. The ninety-day period derives from the U.S. sources and is intended to ensure the availability of the information in the period immediately following the distribution.

The prospectus delivery requirements of this section also apply to a statement of material facts, that is, a prospectus for a distribution made through the facilities of a stock exchange.³¹ Although identification of the ultimate purchaser may be difficult where a distribution is made through the open market during normal trading hours,³² identification of the purchaser's broker is not; and the requirements of the section may be satisfied by delivery to him.³³ The subsection thus provides an incentive for underwriters to distribute prospectuses to all registrants who may then advise their clients on the basis of the information contained in them.

The prospectus delivery requirement is also broader than those in the source provisions in another manner. The provincial statutes and the *ALI Code* impose a duty to deliver a prospectus only to a purchaser of a security in the distribution. The Draft Act applies to all securities of the class of security being distributed

30 See section 2.40.

31 See section 5.14 and Commentary; and see, *Grover & Baillie* following n. 413.

32 See *id.* at n. 298.

33 See subsection (4); and see Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. AD. 325, 405-06 (1965).

during the specified time so that the disclosure contained in the filed documents may be made available to all purchasers of the security and not just to those who buy it in the distribution. As a result, purchasers in the aftermarket receive information that the seller may have received only a few days earlier. Subsection (3) facilitates this process by requiring the issuer, selling security-holder or underwriter to provide copies of the disclosure documents to any registrant who requests them so that he may comply with the section. However, as a right of rescission and the remedies for a false prospectus are available only to persons who purchase a security pursuant to the distribution,³⁴ the Commission may wish to require disclosure of the source of the security sold – or at least the fact that it is sold in a distribution – in the confirmation slip sent to each purchaser.

The delivery requirement in the *ALI Code* does not apply to reporting issuers that have been registered and have made regular disclosures for one year or more because there is already a substantial amount of public information concerning them.³⁵ For similar reasons Grover and Baillie recommend that the ninety-day requirement apply only to new issues by non-reporting issuers.³⁶ Subsection (2) authorizes the Commission to specify different periods for different classes of reporting issuer and to remove the delivery requirement altogether for those whose securities are widely traded and carefully followed by investment analysts. The Commission may also permit a shorter delivery period in respect of particular distributions by any issuer by means of its exempting power under section 3.03.

Sections 5.05 and 5.06

Section 5.05 authorizes the Commission to specify the nature of the information required in a prospectus and subsection 5.06(1) specifies similar requirements for a preliminary prospectus. The details of the particular facts to be disclosed are left to the Commission which permits them to be adapted to changing needs without legislative revision. In keeping with this approach, the Draft Act leaves the question of who will sign the document and the inclusion of statements as to rescission rights to the regulations.

Subsection 5.05(2) requires the Commission to devise regulations that enable reporting issuers to incorporate by reference or omit information that has already been disclosed to the public or

34 See sections 5.15, 13.05.

35 See ALI FEDERAL SECURITIES CODE, s. 512(c).

36 See Grover & Baillie at nn. 434–38.

filed with the Commission. The Commission may develop a number of types of shorter prospectus depending upon the stability of the issuer and the nature of the security being distributed.³⁷ While it might be desirable to have a short form for small issuers in order to reduce their costs of distribution, the greatest investor need for information is likely in connection with first issues by smaller entities.

A summary prospectus may be used as the basis of an offer to sell a security after a prospectus has been accepted by the Commission (section 5.03). That concise document is intended to enable investors to understand more readily the contents of a complex prospectus by summarizing it and possibly by omitting unnecessary details. Subsection 5.05(4) draws attention to the possibility of allowing the Commission to require an introductory summary in a lengthy prospectus.³⁸ An introductory summary is not intended to provide an alternative to a summary prospectus as it will always be part of the full document.

The purpose of section 5.06 is to permit an issuer to generate interest in his securities before a prospectus is filed and accepted by the Commission. The "preliminary" prospectus may be a copy of the draft prospectus filed with the Commission which normally omits pricing information. The Commission should, of course, have the power to permit the omission of further information that would otherwise be required in a prospectus (paragraph 5.06(1)(e)).

The preliminary prospectus has not been widely used as a selling document in Canada and its use should be encouraged. The Draft Act attempts to encourage such use by not requiring filing and by limiting the possible liability it can generate. The omission of a filing requirement may present an opportunity for abuse in rare cases, but these cases can be taken care of through other provisions of the statute, including a requirement to file the preliminary with the final prospectus if any abuse is indicated in a particular case. If the offering in connection with which a preliminary prospectus is used is successful, an investor will purchase the securities in the distribution after a receipt for the final prospectus is issued by the Commission and will be entitled to the remedies relating to that document under section 13.05 if there is any misrepresentation in it. If there was a material misrepresentation in the preliminary prospectus which is corrected in the final, it is questionable whether the purchaser should be entitled to a remedy

37 See e.g. *Grover & Baillie* at nn. 350-51 and following; cf. L. LOSS & E. COWETT, *BLUE SKY LAW* 359-60 (1958) ("blue chip" exemption).

38 See e.g. *Grover & Baillie* following n. 353; cf. P. ANISMAN at 203-08.

against either the issuer or the underwriter. The argument in favour of the imposition of a remedy lies in the possibility that the investor will not be aware of the correction. But the Commission can require filing of the preliminary with the final prospectus, as noted above, and if the former is misleading can require the final prospectus to carry a prominent notice of correction.

Section 5.07

Because the definition of "distribution" includes sales of securities by controlling persons and by sophisticated investors, it is possible that a prospectus or block distribution circular will be required to be filed by a person who has no access to the issuer's records. The Draft Act, following the provincial securities acts, authorizes the Commission to require the issuer to provide the selling securityholder with the necessary information and permits it to impose conditions to protect the legitimate interests of the issuer and its other securityholders. And if production of the information involves substantial cost for the issuer, the Commission may impose a condition requiring the selling securityholder to indemnify it.³⁹

An unconditional order made under section 5.07 could require the premature disclosure of plans that would be harmful to the issuer. This possibility would be greatest in a distribution within paragraph 2.17(d), for example, a distribution by an institutional investor, and highlights the fact that a block distribution circular must differ substantially from an ordinary prospectus. Indeed, as was said above, it is expected that the circular will emphasize market information influencing the seller's decision to sell rather than detailed information concerning the issuer, most of which is likely to be on file with the Commission in any event. In the few cases in which a conflict does arise between full disclosure in a prospectus and protection of the issuer's plans, the Commission may either delay acceptance of the prospectus or grant an exemption under its general exempting power in section 3.03.

Section 5.08

All of the source provisions establish a maximum life for a prospectus after which a distribution must cease unless the prospectus is amended to bring up-to-date the information contained in it,⁴⁰ or unless a new prospectus is filed.⁴¹ Section 5.08 accom-

39 See e.g. *Grover & Baillie* at n. 345 and following.

40 See ALI FEDERAL SECURITIES CODE, s. 508(a)(2).

41 See e.g. Ontario Securities Act, s. 56.

plishes the same result by limiting a distribution to one year and twenty days unless a current prospectus is accepted by the Commission. The time period in the provision derives from the provincial legislation. As mutual funds, the type of issuer most commonly making a continuous distribution, are not subject to the disclosure provisions of the Draft Act,⁴² section 5.08 is not likely to be frequently applied. Nevertheless, it is a necessary provision in any securities act.

Subsection (2) empowers the Commission to reduce the period to six months either generally or in specific instances. It is understood that most equity issues are completed within six months and by that time it is likely that the prospectus would require amendment in any event, especially as the financial statements contained in it would be almost a year old. The same is true of most debt issues. However, some medium-term debt issues are sold as market conditions permit and the distribution period for such "tap" issues may exceed six months. As a determination of the appropriate period should be based on empirical information concerning the actual period of distributions, the subsection enables the Commission to reduce the period by regulation after it has available to it the information necessary to decide this issue.⁴³

Section 5.08 complements section 5.11 which requires an issuer or selling securityholder to distribute at least one quarter of the securities offered within three months of the date of the receipt for the prospectus or halt the distribution.⁴⁴ Read together these two sections require that a distribution obtain a "minimum subscription" of 25% within three months and conclude within a year or a lesser period determined by the Commission. The Commission may, of course, permit a particular distribution to continue beyond the specified periods through the exercise of its general exempting powers in section 3.03, subject to any conditions it thinks necessary to ensure that adequate information is available to investors. (A similar power, to extend the time permitted for a distribution, is expressly granted in the Canadian source provision.⁴⁵) The Commission will presumably be more inclined to exercise its exemptive powers in relation to reporting issuers and "tap" issues in the few cases where they do not meet the 25% requirement. Conversely, the Commission may shorten the one-year period in respect of a particular distribution if it believes that a sufficient reason to do so exists.

42 See subparagraph 3.02(1)(c)(iv) and Commentary.

43 Cf. ALI FEDERAL SECURITIES CODE, s. 508(a)(2) (nine months).

44 Cf. section 5.04 and Commentary.

45 See e.g. Ontario Securities Act, 1978, s. 63(5).

Section 5.09

Although a prospectus that fully discloses information concerning the issuer and the securities offered may enable a knowledgeable investor to assess rationally the risks involved in purchasing securities in the distribution, it is not clear that all investors read the prospectus or even that the less sophisticated among them would understand it if they did. Indeed this fact has been demonstrated by the success of distributions where the issuer was virtually doomed to fail.⁴⁶ The limitations inherent in the use of disclosure as an exclusive method of protecting investors, especially when considered in the context of the sales effort that usually accompanies a distribution,⁴⁷ indicate the need for further investor protection that has led most jurisdictions with securities legislation to adopt some form of "merit regulation".⁴⁸

The Draft Act therefore follows the Canadian models and authorizes the Commission to deny an issuer or selling securityholder the opportunity to sell its securities to the public, but attempts to structure the Commission's discretion in order to provide some guidance to it and to the courts for purposes of judicial review.⁴⁹

Section 5.09 requires the Commission to issue a receipt for a prospectus or block distribution circular within a reasonable time or to initiate proceedings and make an order refusing to do so. The structure of the section thus circumscribes the Commission's powers to delay acceptance without providing an opportunity to persons making the distribution to be heard. If the Commission or its staff believe that a distribution should not be permitted, a hearing must be convened and notice given to persons directly affected, usually the issuer or selling securityholder and the underwriter.⁵⁰

The same procedure applies to a statement of material facts, that is, to a "prospectus" for a distribution made through the facilities of a registered securities exchange, which is expressly made subject to the Commission's blue sky discretion under section 5.09.⁵¹ If a hearing concerning such a distribution is convened, the exchange too is arguably directly affected.

46 See e.g. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 L. & CONTEMP. PROBS. 193, 211, n. 110 (1958).

47 See e.g. Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 635-36 (1973).

48 See e.g. L. LOSS & E. COWETT, BLUE SKY LAW 324-30 (1958) (Uniform Securities Act, s. 306(a)).

49 See generally, *Grover & Baillie* at nn. 177-82.

50 See subsection (2) ("by order") and section 15.17; cf. Ontario Securities Act, 1978, s. 60(3) (person who filed prospectus).

51 See section 5.14 and Commentary.

Subsections (2) and (3) establish the standards governing exercise of the Commission's blue sky discretion. The approach adopted is a composite of that in the Canadian and U.S. source provisions. Subsection (2) lists a number of specific criteria the Commission may invoke to refuse to qualify a prospectus and also grants it a residual discretion that, while wide, attempts clearer definition than that in the present Canadian acts by including the "fair, just and equitable" standard with which there is experience under a number of U.S. acts.⁵² It is worth mentioning that the subsections are structured so that the Commission's staff bears the burden of establishing the existence of any of the circumstances necessary to justify a refusal.⁵³

The Commission's discretionary powers concerning prospectuses and block distribution circulars are dealt with separately in subsections (2) and (3), respectively, because not all of the criteria enunciated are applicable to a distribution made by persons who are not in a position to control the issuer's activities. For example, the fact that the issuer is controlled by persons of disreputable character or that a large commission is paid to an underwriter (paragraphs 5.09(2)(c) and (e)) should not influence the fairness of a "block distribution", for in both cases the distribution merely involves trading in the market between persons who are independent of the issuer in circumstances where the only factor necessitating the filing is the volume of securities being traded.⁵⁴ Similarly paragraph (2)(d) is clearly directed at distributions by the issuer itself.

A few more detailed comments on the standards in subsection (2) may be useful. Paragraphs (a) and (b) deal primarily with disclosure and "fraudulent" conduct and are therefore clear. The standard in paragraph (c) is directed at inordinate compensation to either the promoters or the underwriters and has long been a subject of serious concern.⁵⁵ And paragraph (f) reflects a power that has long existed in the Canadian legislation and is now included in the blue sky section of the new Ontario legislation.⁵⁶

Paragraph (e) is essentially intended to permit the Commission to prevent distributions by issuers that are controlled by persons whose past conduct indicates that they are not deserving

52 See paragraph (g); *Grover & Baillie* following n. 183; and see e.g. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?* [1976] Wisc. L. Rev. 79.

53 Compare California Corporate Securities Law of 1968, ss. 25140(a) and (b).

54 See paragraph 2.17(d) and Commentary.

55 See e.g. L. Loss & E. COWETT, *supra* note 48, at 324-25, 329-30 (s. 306(a)(F)); and see *In re Galaxy Gold Mines Ltd.*, [1975] OSC Bull. 57 (February).

56 See e.g. Ontario Securities Act, s. 50(6); Ontario Securities Act, 1978, s. 60(2)(i); and see e.g. *In re Kleena Kleene Gold Mines Ltd.*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, July 22, 1977, at 5 (C.F.S.C.).

of the trust of public investors either because of their complete lack of financial acumen or a lack of integrity. The paragraph combines two provisions that were added to the new Ontario legislation and that presumably derived from the U.S. source provisions.⁵⁷ Although the discretion under paragraph (e) is extremely broad, the fact that any refusal based on it is subject to judicial review is likely to ensure that it will be exercised reasonably.⁵⁸

The Draft Act makes no attempt to require the Commission to refuse a prospectus. Any such requirement would likely force the Commission to incorporate the discretionary element of its decision into the determination of whether the statutory conditions have been fulfilled or would lead it to treat a matter within its residual discretionary powers.⁵⁹ The discretionary approach of subsections (2) and (3) enables the Commission to accept a prospectus even though the distribution may fall within one of the provisions of subsection (2), and thus emphasizes, albeit indirectly, the expectation that the Commission's blue sky powers are to be exercised sparingly and then only when the Commission is unable to impose conditions that will rectify the unfairness. In other words, the goal of the provision is to require the Commission, where possible, to apply disclosure and other remedial techniques short of refusal.

The discretionary powers in subsections (2) and (3) are therefore effectively integrated with the Commission's authority under subsection (4) to require an issuer or selling securityholder to meet conditions necessary to protect investors before it accepts a prospectus or block distribution circular. Subsection (4) authorizes the Commission to impose any conditions as protective devices that will protect investors and, at the same time, avoid barring an issuer from access to the marketplace. As a result, the Commission's discretion to impose conditions is necessarily broad, and the specific examples in paragraphs (4)(a) to (c) are not intended to limit it. Rather they incorporate two of the traditional methods used by securities administrators to ensure that public investors are treated equitably: first, the requirement that securities issued for promotional or similar services be held in escrow so that money obtained in a distribution may go to the issuer, and second, the requirement that money received be held in trust and returned to purchasers if the minimum amount needed to accomplish the issuer's goals is not obtained.

57 See Ontario Securities Act, 1978, ss. 60(2)(d)-(e); California Corporate Securities Law of 1968, ss. 25140(a)-(b); cf. *In re Shoppers Investment Ltd.*, [1972] OSC Bull. 215 (October).

58 See section 15.19.

59 See e.g. Ontario Securities Act, 1978, s. 60; cf. *In re Galaxy Gold Mines Ltd.*, *supra* note 55.

Paragraph (4)(c) makes clear that the Commission is not limited to traditional types of requirements. It authorizes the Commission to delay a distribution, even where the prospectus is acceptable, or to accomplish the same result by extending the period during which a purchaser may rescind a purchase made in the distribution. These techniques are included as possible means of ensuring that investors are not stampeded into making too hasty investment decisions as a result of heightened sales efforts or the existence of a "hot issue" market.⁶⁰

It is worth emphasizing that the Commission may exercise its powers under subsection (4) by order or by regulation. The former procedure will be utilized for the application of its policies to particular distributions and for novel cases. In the common type of case, regulations will enable the Commission to classify various types of issuers and prescribe conditions generally appropriate to them.

Section 5.10

Section 5.10 is one of the two provisions that are intended to facilitate coordination of the distribution requirements under the Draft Act and the provincial securities acts. This section requires the Commission to issue a receipt for a prospectus that has been accepted by a provincial commission or administrator under local legislation. The complementary provision exempts intraprovincial distributions from the requirements of part 5.⁶¹ The two provisions together enable a provincial government to establish the standard of investor protection for all distributions in the province⁶² and make clear that no conflict exists between part 5 and any provincial prospectus provisions that continue in force even if they impose less stringent requirements than the Draft Act.⁶³

The interrelationship of the intraprovincial exemption and section 5.10 requires explanation. Distributions made exclusively in a single province by a local issuer for a local purpose have minimal impact outside of the province and consequently are exempted from the prospectus requirements of part 5. Section 5.10 applies only to distributions that are subject to this Part, that is, to distributions intended to be made in more than one province. In such cases issuers are likely to file with the Commission in order to be able to sell their securities in the provinces that have delegated

60 See *e.g. Grover & Baillie* at nn. 190-91 and following.

61 See section 6.05 and Commentary.

62 Cf. *Anisman & Hogg* at nn. 197-99 and following.

63 See *id.* ch. III.8.

the clearance of new issues to it⁶⁴ and to facilitate acceptance in the other provinces. The Commission will be required therefore to deal with the prospectus pursuant to section 5.09. If after a hearing the Commission decides to refuse to issue a receipt pursuant to subsection 5.09(2), it must still issue the receipt where the distribution has been accepted by a provincial administrator; but it may limit the effect of the receipt to the province in which the distribution has been approved and the securities may be sold only in that province.

It is likely that the section will rarely, if ever, have any effect because the provincial commissions will probably coordinate their vetting of a prospectus with the Commission's and because they will probably be reluctant to permit a distribution that has been refused by the Commission, after a hearing, pursuant to the standards specified for the exercise of its blue sky discretion.⁶⁵ Nevertheless, the provision is included to ensure comprehensive coverage in the Draft Act of the various areas that may require coordination of the federal and provincial regulatory schemes.

Block distribution circulars, however, do not receive the same treatment. A distribution for which such a circular is required will almost invariably be made in the secondary market, usually through a securities exchange, so that the distribution circular in effect serves the same purpose as a press release or cease trading order, that is, to explain the large number of securities being sold into the market. As the Commission will have primary responsibility under part 9 for the regulation of securities exchanges, a distribution within paragraph 2.17(d) may not be made unless it complies with the requirements of the Draft Act. In any event, because such distributions are not covered by the provincial acts, their inclusion would be superfluous.

Section 5.11

Section 5.11 supplements the blue sky provisions of section 5.09 by precluding "shelf-registrations" and imposing a minimum subscription requirement. A "shelf-registration", that is, a prospectus filed with the Commission to cover securities that are intended to be sold at a later date, would permit a distribution to begin after the period during which delivery of the prospectus is required by section 5.04 and thus deprive investors of some of the protection granted under the Draft Act. Moreover, it would complicate the disclosure process because amendments to the prospec-

64 See section 15.06.

65 See subsection 5.09(2) and Commentary.

tus are likely to be required by section 5.12, at least until the prospectus expires.⁶⁶ Subsection 5.11(1) therefore establishes a maximum period within which a distribution must be initiated, and subsection (2) defines initiation as the sale of one quarter of the securities offered.

The section thus requires a substantial effort to sell the securities within the ninety-day period. Otherwise the distribution must cease and a new prospectus be filed with and accepted by the Commission before more securities may be sold. (The ninety-day period derives from the source provision.) The incidental effect of this method of ensuring a serious sales effort, by requiring a minimum subscription within the ninety-day period, is to enhance the treatment of purchasers whose money may be held in trust during this period.⁶⁷ In this regard the provision is complemented by section 5.08.⁶⁸

Nevertheless, an issue of medium-term debt securities that are intended to be sold as circumstances permit may not be able to fulfill the requirements of the section.⁶⁹ This matter is left to the exempting power under section 3.03.

Section 5.12

This section needs little explanation. Like all of the source provisions it requires that a prospectus be amended when a change constituting a material fact occurs while a security is being distributed in order to make the new information available to investors whose decision to purchase may be affected by it. A failure to comply with the section would in any event render a prospectus misleading and make the issuer, underwriter, directors and officers who know of the fact liable to purchasers under the provision creating liability for a false prospectus.⁷⁰ Conversely, the amendment provides a defence against any person who purchases the securities after the date on which it is made.⁷¹

The section does not apply to a block distribution circular because the selling securityholder will not have access to information relating to the issuer. In fact, as a block distribution circular is likely to contain information relating primarily to the market for the security being distributed and to the seller's reasons for selling, it is doubtful that amendments to it will become

66 See section 5.08.

67 See paragraph 5.09(4)(b).

68 See section 5.08, Commentary.

69 See *id.*

70 See section 13.05.

71 See subsection 13.05(4).

necessary.⁷² And if the Commission's experience indicates that they are, it may require that they be filed as a condition of issuing a receipt under section 5.09.

Unlike the prospectus itself, an amendment need not be accepted by the Commission before it "becomes effective", as such a requirement might delay its use along with the prospectus when the distribution is already in progress. Rather the amendment may be used immediately. If it results in a misrepresentation or alters the nature of the distribution materially, the Commission may issue a cease trading order under section 14.03.

Section 5.13

While section 5.03 specifies the minimum amount of information that must accompany any sales effort during a distribution, it does not establish limits on the type of materials that are permissible and it does permit registrants to solicit expressions of interest without sending disclosure documents. Section 5.13 approaches this issue from the opposite direction by authorizing the Commission to prohibit or to establish criteria limiting the use of any advertising or other informational material in connection with a distribution. In short, the Commission may establish standards for promotional materials either in specific instances or generally and may require them to be filed in order to facilitate enforcement.

Section 5.14

Before 1966, distributions of securities made through the facilities of a stock exchange were exempted from the prospectus requirements under the securities acts.⁷³ The exemption was criticized in a number of official reports.⁷⁴ Nevertheless, the procedure was allowed to continue but in varied form to prevent the abuses demonstrated by past experience. The rules of the exchange were tightened and a statement of material facts containing information equivalent to that in a prospectus was required to be filed with and "acceptable to" both the exchange and the securities commission.⁷⁵ Since 1966 the device has apparently proved useful and there have been no obvious cases of abuse.⁷⁶

72 See paragraph 2.17(d) and Commentary.

73 See e.g. R.S.O. 1960, c. 363, s. 41(b).

74 See e.g. KIMBER REPORT, pt. VII; PORTER REPORT at 340-42; WINDFALL REPORT at 113, 120-21 (recommending separate mining exchange); but see Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. AD. 325, 398-405 (1965).

75 See e.g. Securities Act, 1966, S.O. 1966, c. 142, s. 58(2)(b).

76 See D. BEATTY, REPORT ON MATTERS RELATED TO THE FINANCING OF MINING EX-

In light of the experience with distributions made through an exchange since 1966, that is, since the requirement that a statement of material facts be filed with and acceptable to a commission has been in force, and in light of the fact that this method of distributing securities is available only to reporting issuers, the Draft Act permits the practice to continue.⁷⁷

Section 5.14 allows the advantages of a "securities exchange distribution" without depriving investors of the protection otherwise available under the Draft Act. This latter goal is effectuated in two ways. Subsection (2) provides that a statement of material facts is a prospectus. (The drafting of the section avoids the usual "deeming" language, as a conclusive presumption is in effect a rule of law, and states the substantive provision directly, an approach that is taken throughout the Draft Act.⁷⁸) As a result, all of the provisions of the Draft Act applicable to prospectuses, including those creating liability for a false prospectus, apply to a statement of material facts. It is therefore unnecessary, for example, to include a separate provision authorizing the Commission to prescribe the contents of a statement of material facts as section 5.05 already does so.⁷⁹

However, a number of sections in this Part apply expressly to a prospectus filed pursuant to section 5.02 and would not, without more, include a statement of material facts. Sections 5.04 and 5.09 therefore refer expressly to a prospectus filed pursuant to section 5.14, so that the prospectus delivery requirements and the Commission's blue sky discretion are applicable to a distribution made through the facilities of a registered securities exchange.⁸⁰

Section 5.15

A two-day right of rescission was initially granted to purchasers in Canada as a result of a recommendation by the Kimber Committee.⁸¹ Although it has been suggested that the right is "more illusory than real",⁸² the provision has generally been adopted in the provincial acts, is continued in the new Ontario act

PLORATION AND DEVELOPMENT COMPANIES, ch. I (1968); and see, *Grover & Baillie* following n. 414. For a description of current practices, see *id.* at nn. 295-98.

77 See, *Grover & Baillie* at n. 415 and following.

78 See e.g. LAW REFORM COMMISSION OF CANADA, EVIDENCE: BURDENS OF PROOF AND PRESUMPTIONS 59 (July 1973) (Evidence Project's Study Paper No. 8); R. CROSS, EVIDENCE 111 (4th ed. 1974); but see E. DRIEDGER, THE COMPOSITION OF LEGISLATION 133 (2d ed. 1976).

79 Compare e.g. Ontario Securities Act, 1978, s. 72(1)(b).

80 See sections 5.04, 5.09 and Commentary.

81 See KIMBER REPORT, ¶ 5.29; Securities Act, 1966, S.O. 1966, c. 142, s. 63.

82 D. JOHNSTON at 180.

and has been included in the *ALI Code*.⁸³ The Draft Act includes a similar right in order to ensure that investors at least have an opportunity, before they are bound, to discover the contents of a prospectus either directly or through their brokers.

Some overlap exists between the prospectus delivery requirement in section 5.04 and that in section 5.15. The former section requires that a prospectus or equivalent document be sent during the first ninety days of a distribution to all purchasers of a security of a class of securities being distributed whether or not the security is purchased in the distribution.⁸⁴ Section 5.15, on the other hand, applies only to purchasers of securities in the distribution however long it lasts. Together the two sections enhance the likelihood of wide dissemination of the information contained in a prospectus during a distribution.

The section provides an incentive for underwriters to distribute a prospectus early because the time of receipt by the purchaser's agent limits the actual availability of the remedy.⁸⁵ In fact, early distribution of a prospectus is common practice so that even in the rare case of a distribution made in the open market through the facilities of an exchange, a purchaser's agent will have received a copy of the prospectus before the sale.

83 See e.g. Ontario Securities Act, s. 64; Ontario Securities Act, 1978, s. 70; ALI FEDERAL SECURITIES CODE, s. 504(b); and see *id.*, Tent. Draft No. 1, s. 503(b) and Comments.

84 See section 5.04, Commentary.

85 See paragraph (3)(a); subsection 5.04(4) and Commentary; and cf. ALI FEDERAL SECURITIES CODE, ss. 504(b)(1), (2).

Part 6

Exemptions from Prospectus Requirements

Traditionally exemptions from the disclosure requirements for distributions have fallen into two categories, the first based upon the nature of the securities sold and the second on the type of transaction involved.¹ The former class of exemption is treated in part 3 both on an act-wide basis and in connection with the disclosure provisions; the latter provides the focus of part 6.

An exemption from the prospectus requirements of part 5 is available in respect of a transaction that constitutes a distribution as defined in section 2.17 if the transaction is such that a prospectus is not necessary to enable a purchaser to make a rational investment decision, or if the cost and time entailed in providing the information and preparing a prospectus are substantially out of proportion to the benefit to investors. Part 6 thus exempts from part 5 transactions where the purchaser is both able to obtain information equivalent to that contained in a prospectus and to understand and evaluate it² and transactions in connection with which essentially the same information is required to be disclosed under other provisions of the Draft Act.³

Several of the exemptions are granted primarily because no

1 *See e.g.* Ontario Securities Act, ss. 58(1), (2); Ontario Securities Act, 1978, ss. 34, 71; L. LOSS & E. COWETT, BLUE SKY LAW 352-79 (1958) (Uniform Securities Act, ss. 402(a), (b)); and *see*, Grover & Baillie, ch. VI.D.

2 *See e.g.* ss. 6.01(a), (b), 6.02.

3 *See e.g.* ss. 6.01(e), (f).

new risk to investors is involved in the transaction,⁴ because the investor should already be well acquainted with the issuer,⁵ or because of a desire to avoid imposing an unnecessarily heavy burden on a seller in light of the limited risk to investors.⁶

These factors are not, however, the only considerations underlying the part 6 exemptions. Other policy elements combine with them and in a few cases may even provide the dominant impetus for an exemption. For example, a desire to promote investment in business enterprises was one of the factors that resulted in the exemption for rights offerings in paragraph 6.01(d); was likely an important factor in connection with the exemption for sales of securities to employees in paragraph 6.01(g), and was a major influence in the development of the limited offering exemption in section 6.03.⁷

The exemptions in part 6 derive from the provincial securities acts and from experience in the United States. Because these *Proposals* contain recommendations for federal regulation of the Canadian securities market, it is necessary to consider the relative regulatory roles of the provincial and federal governments. Part 6 includes an exemption for intraprovincial distributions, that is, for distributions of securities made exclusively to residents of one province (section 6.05). Under the Draft Act each provincial legislature has power to establish the level of investor protection for its own residents, at least where only they are affected, and especially so for distributions that are important to provincial policy concerning the exploitation of natural resources.⁸ Section 6.05 also reinforces Parliament's jurisdictional basis for the enactment of legislation regulating other new issues of securities.⁹

The scheme of exemptions in the Draft Act differs from the Ontario Securities Act, 1978. The latter act imposes a closed system on distributions of securities so that the initial sale to a public investor of a security, whether or not it was previously sold under an exemption from prospectus disclosure, requires the filing of a prospectus unless the issuer of the security is a reporting issuer and the security has been held for a specified period.¹⁰ The *ALI Federal Securities Code* too moves closer to achieving a closed system.¹¹

4 See e.g. ss. 6.01(c)(i), (ii).

5 See e.g. s. 6.01(d).

6 See e.g. ss. 6.01(h), 6.04.

7 Cf. ss. 1.02(a), (b).

8 See e.g. B. KALYMON, P. HALPERN, J. QUIRIN & W. WATERS, *FINANCING OF THE JUNIOR MINING COMPANY IN ONTARIO* (1978) (study prepared for Ontario Ministry of Natural Resources); see also section 3.02, Commentary; and cf. section 5.10 and Commentary.

9 See, *Anisman & Hogg* at nn. 197-99 and following.

10 See Ontario Securities Act, 1978, s. 71.

11 See *ALI FEDERAL SECURITIES CODE*, s. 242, part 5.

The Draft Act does not create a closed system that always requires the filing of a prospectus before securities of an issuer may be sold to a public investor. Instead it adopts a scheme between the closed distribution system of the new Ontario legislation and the present provincial acts which in effect permit sales of securities to the public by intermediaries that are not affiliated with the issuer. In brief, the Draft Act attempts to ensure that large amounts of securities will not be sold to public investors by means of the exemptions without prospectus disclosure, while permitting the sale of small amounts of securities of reporting issuers by means of anonymous sales into the market and the sale of securities of non-reporting issuers by means of direct transactions. The Draft Act thus achieves a balance which avoids the imposition of restrictions on resales of securities that do not create a risk to large numbers of investors but which precludes the use of the exemptions as a device to accomplish a wide distribution of securities without complying with the prospectus provisions in part 5.

Section 6.01

Section 6.01 contains a number of relatively straightforward, if somewhat diverse, exemptions that are derived primarily from the Canadian source provisions and are intended to facilitate transactions by issuers and securityholders where the purchaser does not need the full prospectus protection provided under part 5. The reasons behind the exemptions are, not surprisingly, as various as the exemptions themselves.

Paragraphs (a) and (b) are intended to facilitate transactions by securities professionals in furtherance of a distribution; securities may be sold by the lead underwriter to members of the banking group and by the latter to members of the selling group without compliance with part 5. An underwriter may therefore enter arrangements for the distribution of a security without having to file and circulate the materials, such as a preliminary prospectus, that would otherwise be required.¹²

Paragraphs (c) and (d) are intended to avoid the imposition of substantial costs on an issuer in circumstances where the benefits to investors would be minimal.¹³ The former paragraph exempts stock dividends, distributions of securities to securityholders in a reorganization or dissolution of the issuer and the "sale" of a security pursuant to the exercise of a right to acquire it where the right was issued by the issuer. (Subparagraph (iii) thus does not deal with calls.) In all three cases the "purchaser" of the security

¹² See sections 5.03, 5.06.

¹³ See e.g. *Grover & Baillie* following n. 397.

will be familiar with the issuer's activities as a result of his securityholder status. The first two types of distribution have long been exempted by the provincial securities acts.¹⁴ The third class was recently added to the Ontario act and included in the 1978 act in order to avoid the filing of a double prospectus for what is in effect a single issue of securities.¹⁵ Only the exemption for stock dividends requires that the securities distributed by the issuer also be issued by it, for such a limitation would substantially reduce the utility of the other two exemptions.

As the exemption is contingent on there being no sales effort in connection with the distribution, information concerning material facts that have occurred since the release by the issuer of the last publicly available disclosure document should be sufficient to protect investors. And disclosure of such data is required by the insider trading provisions in parts 12 and 13.

The exemption for rights offerings in paragraph (d) is based on similar considerations. However, because a rights offering involves a direct attempt by an issuer to raise capital through the sale of its own securities and especially because the exemption is available to all issuers, whether or not they have registered under part 4, other conditions are imposed for the protection of investors. Paragraph (d) therefore exempts the issue and exercise of rights only where the issuer has filed with the Commission a notice containing information prescribed by the Commission that it intends to send to its securityholders. It is expected that the Commission will require the information now required under the provincial legislation, namely, "the date, amount, nature and conditions of the proposed" sale, including the amount to be obtained by the issuer.¹⁶ The Draft Act leaves the details of the information to regulations, here as elsewhere, to enable the Commission to adopt requirements appropriate to the issuer and to require additional information without the need to deny exemptions conditionally.¹⁷ The "notification procedure" in subparagraph (iii) places the onus on the Commission to prohibit a rights offering that it considers improper, thus drawing a balance that should encourage this type of distribution.¹⁸

Paragraphs (e) and (f) are intended to avoid unnecessary duplication of filings, as they exempt transactions for which full

14 See e.g. *Grover & Baillie* at nn. 395-97.

15 See Ontario Securities Regulations, s. 88; Ontario Securities Act, 1978, s. 71(1)(h)(ii); cf. ALI FEDERAL SECURITIES CODE, s. 5.12(g) (continues U.S. practice of requiring separate prospectus, usually by means of a shelf registration).

16 Ontario Securities Act, 1978, s. 71(1)(h).

17 Cf. e.g. *Grover & Baillie*, n. 397.

18 See *id.* following n. 397.

disclosure to the investors concerned is required either under the applicable corporate legislation or under the Draft Act. Transactions within paragraph (e) require approval of securityholders and therefore the solicitation of proxies and those within paragraph (f) require a takeover bid circular containing information like that in a prospectus to be sent to offerees.¹⁹ Because such documents must generally be filed with the Commission under part 7 a similar requirement is not included here, but in the event of abuse the Commission may deny the exemptions pursuant to section 3.04. In addition, parts 12 and 13 provide remedies to persons who make an investment decision on the basis of false information in a proxy or takeover bid circular.

The provincial source provisions also exempt offers that are excluded from the definition of "takeover bid", that is, so-called "exempt takeover bids".²⁰ However, because the exemption for such offers from the takeover bid provisions is based primarily upon a lack of pressure on offerees in the specified transactions, rather than on their not requiring the information that would otherwise be included in a takeover bid circular or in a prospectus, the transactions are not exempted from the prospectus provisions of the Draft Act.²¹

The exemption for distributions to employees included in paragraph (g) has long been a part of Canadian securities law, despite the contrary position in the United States,²² presumably in order to encourage investment by employees in the corporation that employs them.²³ The scope of the exemption has also been questioned in Canada on the basis that employees frequently require the information contained in a prospectus and should not be the target of a distribution without it.²⁴ The Draft Act continues the exemption on the ground that its original policy basis remains valid, but imposes a further limitation on its availability so that no pressure of any kind may be brought to bear on employees in connection with a distribution. Not only may promises of continued employment not be made, but the exemption is not available if any sales efforts are used in connection with the transactions.²⁵

The exemption in paragraph (g) permits the sale by an issuer of securities of its affiliates and thus enables a holding company to

19 See parts 7B, 7D.

20 See e.g. Ontario Securities Act, 1978, s. 71(1)(k); cf. Draft Act, s. 7.19(a).

21 See e.g. P. ANISMAN at 194-96.

22 See, SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

23 See e.g. ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT, ¶ 8.07.

24 See, Iacobucci at nn. 126-27; Grover & Baillie at nn. 393-94 and following.

25 See subparagraph (g)(ii); cf. paragraph (c).

distribute to its employees the securities of its subsidiary. In this regard the paragraph follows the Canadian models. It also follows these models in permitting the sale of securities other than equity securities on the ground that an investment of any nature by an employee creates many of the benefits of employee participation in the welfare of an enterprise.

The isolated sale exemption in paragraph (h) has a long history in North American securities legislation²⁶ and under the new Ontario act it has been extended, and limited, to issuers.²⁷ While the exemption in the Draft Act differs from its Canadian predecessors, it is central to the disclosure scheme in part 5.

Briefly, paragraph (h) is intended to supplement the other exemptions from part 5 by enabling investors and issuers to sell some of their securities in circumstances where harm to investors from the lack of a prospectus is likely to be minimal. Reporting issuers may also use the broader trading transaction exemption in section 6.04 and both reporting and non-reporting issuers may use the sophisticated purchaser and limited offering exemptions in sections 6.02 and 6.03.

The isolated sale exemption can be understood only in the light of the definition of "distribution" in paragraphs 2.17(b) and (c). Under paragraph 2.17(b) any sale by a person who purchased his securities from a non-reporting issuer is a distribution, as is a sale by a person who within the preceding six months or other period specified by the Commission purchased securities from a reporting issuer. Under paragraph 2.17(c) any sale by a control person is also a distribution. Paragraph 6.01(h) therefore permits any such person to sell his securities in a single transaction so that he is not required to hold the securities indefinitely or even for the period specified in paragraph 2.17(b). In this manner the Draft Act enables an initial purchaser in a distribution for which a non-reporting issuer files a prospectus to dispose of his securities even though he may not use the trading transaction exemption in section 6.04. As a result, he is not locked into his investment. The isolated sales exemption thus facilitates as well the use of limited offerings under section 6.03.

The number of permissible sales is limited, however, in order to ensure that public investors are not subjected to a widespread distribution through the use of the exemption. It is expected that the Commission and the courts will interpret "continued and successive sales" in a manner designed to accomplish this end by

26 See e.g. L. LOSS & E. COWETT, *supra* note 1, at 317-18.

27 See Ontario Securities Act, 1978, s. 71(1)(b).

limiting the exemption in the light of experience in Canada and the United States and in the light of the provision's purpose.²⁸

Paragraph (i) is included in section 6.01, despite a substantial overlap with the general exempting powers granted to the Commission by section 3.03, in order to establish the specific standard that the Commission should apply in granting exemptions from the prospectus requirements. Nevertheless, the Commission's powers under the earlier section continue and are exercisable, unlike those under paragraph (i), by regulation as well as by order. It is expected, therefore, that the Commission will deal with types of transactions that are exempt under the provincial legislation but not under section 6.01 by means of the broader power.²⁹ In either case the powers are likely to be exercised sparingly. This likelihood is emphasized by the fact that paragraph (i) enables the Commission to require an issuer or selling securityholder to agree to the standard of civil liability that applies under part 13 to a regular distribution.

Section 6.02

The concept of "the public", which has traditionally provided the basis for the prospectus requirements, is premised in essence on the need of investors at whom a distribution is directed for information concerning the issuer of the securities.³⁰ As a result virtually all securities legislation in North America exempts sales to financial institutions and to other major investors that are able to evaluate and are in a position to demand information from the issuer equivalent to that required in a prospectus.³¹

The provincial legislation exempts private placements of securities to financial institutions that because of their business activities and resources are presumed to be sophisticated,³² and to this group the new Ontario act adds investors who are assisted by an investment adviser.³³ Section 6.02 follows suit and exempts from the prospectus provisions distributions to both types of investor. However, rather than treating them as equivalent and imposing a ceiling on the number of purchasers to whom an exempt distribution may be made,³⁴ the Draft Act distinguishes profes-

28 See e.g. Interpretation Act, s. 11.

29 See e.g. Ontario Securities Act, 1978, s. 72(1)(c) (puts and calls); and see section 3.02, Commentary.

30 See e.g. D. JOHNSTON at 148-55.

31 See e.g. Ontario Securities Act, 1978, ss. 71(1)(a), (p).

32 See e.g. Ontario Securities Act, ss. 19(1)3, 19(3) and 58(1)(a), (b).

33 See Ontario Securities Act, 1978, s. 71(1)(p); see generally, *Grover & Baillie* at nn. 285-92.

34 Cf. *Grover & Baillie* following n. 344.

sional from nonprofessional investors and imposes a limit only on the number of nonprofessionals to whom a security may be distributed pursuant to the exemption.³⁵

Subsection 6.02(1) exempts from part 5 distributions to the specified financial institutions, all but one of which are included in the provincial models.³⁶ Because registered securities advisers are expected to have financial expertise,³⁷ and because they may manage discretionary accounts for their clients, there is no reason to exclude them from this group of sophisticated investors as the provincial legislation does. The Draft Act adopts the policy of the source provisions and permits exempt distributions to be made to any number of institutional investors.³⁸

Non-institutional sophisticated investors are not treated in the same manner.³⁹ Such investors are generally individuals or groups of individuals who by reason of their wealth are able to make investments sufficiently large to enable them to obtain information concerning the issuer and who either have enough knowledge to evaluate the risk involved in an investment or can retain professional advisers to enable them to do so. They do not, however, have the institutional expertise of a bank or a trust corporation so that a distribution to them resembles more closely a distribution to public investors. As a result subsection (3) limits to fifty the number of sophisticated purchasers to whom a distribution may be made without a prospectus, including as sophisticated purchasers persons who purchase at least \$97,000 worth of securities.⁴⁰ Once the number substantially exceeds fifty, the need for a sales effort by the issuer increases so that prospectus protection is necessary. Subsection 19(3) of the Ontario Securities Act excludes individual purchasers from the exemption but the new act does not. Where sophistication is premised on the size of the transaction there is no reason to exclude individuals. The Draft Act accordingly follows the more recent legislation.

In short, the major difference between institutional and other sophisticated investors is in their ability to demand and assess information from an issuer. The Draft Act assumes that the financial institutions in subsection (1) are in a position to do both. Other investors, however sophisticated they may be and however good their advice, are likely to have less ability to demand information. The Draft Act therefore conditions the availability of the exemp-

35 See subsection (2).

36 See e.g. Ontario Securities Act, 1978, ss. 71(1)(a), (c).

37 Cf. subparagraph (3)(b)(ii).

38 Cf. ALI FEDERAL SECURITIES CODE, s. 242(b).

39 See e.g. *Grover & Baillie* at n. 356 and following.

40 See paragraph (3)(a); cf. Ontario Securities Act, 1978, s. 71(1)(d).

tion for distributions to them on their having access to adequate information.⁴¹ Similarly subparagraph (3)(b)(ii) ensures that the adviser of the purchaser is registered and independent of the issuer. Since the receipt of advice by the purchaser forms the basis of an exemption from the prospectus requirements, it is not unreasonable to require that it be given by a registrant who is not himself involved in the distribution and whose loyalties are not divided.⁴² It is expected that persons in paragraph (3)(c) will receive advice from the insiders to whom they are related. Although the insiders may also have a conflict of interest, they are included on the assumption that they will not deal unfairly with such close relatives. And in any event, all purchasers are entitled to the remedies in part 13.

The numerical limitation too derives from the new Ontario act. The act permits solicitations to be made to fifty potential purchasers but limits sales to twenty-five actual purchasers. The *ALI Federal Securities Code*, s. 242(b), permits thirty-five purchasers but imposes no limit on the number of persons who may be solicited. As the number of persons solicited rather than the number of ultimate purchasers determines the nature of a distribution, the Draft Act limits solicitations and sales to fifty investors.⁴³ The broad definition of sale in section 2.40 makes the dual limitation clear.

Subsections (4) and (5) require persons who sell a security pursuant to this exemption and purchasers who resell a security bought pursuant to the exemption to inform the Commission of their trades so that it can effectively supervise distributions and thus ensure that the exemption is not used as a conduit to avoid the prospectus requirements in circumstances where investors need the protection afforded by part 5. The provisions merely continue the current practice under the provincial legislation.⁴⁴

Subsection (6) is intended to prevent use of the two exempting sections as a vehicle for making a distribution without having to file and deliver a prospectus. It does so by equating the purchaser of a security with the sophisticated purchaser who sells it to him. The subsection thus makes clear that the two persons are to be treated in the same manner for the purposes of paragraph 2.17(b). If, for example, securities were issued by a non-reporting issuer, a second purchaser cannot resell them without filing a prospectus

41 See e.g. Ontario Securities Act, 1978, s. 71(1)(p); cf. *Lawler v. Gilliam*, 569 F.2d 1283 (4th Cir. 1978).

42 But see Ontario Securities Act, 1978, s. 71(1)(p)(ii)(a).

43 See, *Grover & Baillie* at n. 366.

44 See e.g. Ontario Securities Regulations, s. 11; Ontario Securities Act, 1978, ss. 71 (3), (4).

unless he is entitled to an exemption in this Part. If the issuer is a reporting issuer, the second purchaser may resell them in the market when his seller would have been able to do so. And the holding period specified in paragraph 2.17(b) for the securities of reporting issuers continues to run from the date of the issuer's initial sale. Moreover, as the effect of subsection (6) is to make the second purchaser a sophisticated purchaser within section 6.02, his purchasers too are subject to the subsection. In result, subsection (6) both removes the difficulties of an "investment intent" requirement⁴⁵ and ensures that public investors will receive the same protection they would have received had the initial purchaser not sold in an exempt trade. The section thus attempts to strike a reasonable balance that protects investors without imposing unnecessary constraints on issuers of securities.

Section 6.03

Some form of limited offering exemption has long been included in securities legislation in North America in order to enable issuers to obtain capital from a small group without undertaking the expense involved in the filing of a prospectus.⁴⁶ The Draft Act grants issuers a similar privilege in a number of ways. It does not apply at all to an issuer with fewer than fifty securityholders.⁴⁷ But part 5 applies to a distribution that will result in the issuer having more than fifty securityholders. Intraprovincial distributions, however, are exempt under section 6.05, and in many cases the acquisition of capital from a small group of investors, if not exempt from the whole Draft Act, will come within the latter exemption. And in most similar cases an issuer will be able to bring a distribution within the sophisticated purchaser exemption in subsection 6.02(2).

Section 6.03 adds a similar exemption available both to issuers and selling securityholders in order to permit a distribution to a small number of associates who are not likely to require the protection of part 5 even though they lack professional investment advice. The exemption is intended to enable issuers that are larger than the small issuers to which the act does not apply because of paragraph 3.01(e) and are smaller than the large issuers that must register under section 4.02, that is, issuers with more than 50 but fewer than 300 securityholders, to obtain capital as inexpensively

45 See e.g. D. JOHNSTON at 198-99.

46 See e.g. L. LOSS AND E. COWETT, BLUE SKY LAW 368-74 (1958) (Uniform Securities Act, s. 402(b)(9)).

47 See paragraph 3.01(e).

as possible and to encourage investment in such issuers by increasing the liquidity of securities issued pursuant to the exemption.

Section 6.03 derives primarily from the *ALI Federal Securities Code* and the Ontario Securities Act, 1978. It is, however, somewhat broader than the latter and narrower than the former as paragraph 71(1)(p) of the new Ontario act is limited to sophisticated purchasers,⁴⁸ and as the *ALI Code* limits neither the number of offerees nor the ability of a purchaser to resell his securities pursuant to another exemption.⁴⁹ In light of the availability of other exemptions, the Draft Act imposes severe restrictions on a limited offering in order to ensure that it is not used as a vehicle for a two-step distribution without compliance with part 5. It therefore requires a person distributing securities to obtain an agreement from each purchaser not to resell his securities for a three-year period if the sale would bring the number of holders of the security distributed pursuant to the distribution above thirty-five or, if he does so sell, to bear the cost of preparing and filing a prospectus with the Commission. The agreement must be filed with the Commission which may make regulations requiring that reports of subsequent sales be filed in order to facilitate its surveillance of the use of the exemption and which may enforce any such agreement.⁵⁰

The exemption will probably be used more frequently by issuers than by selling securityholders because the latter would likely find it more difficult to obtain the required agreements, and especially because the condition applies even if there are substantially fewer than thirty-five purchasers. In any event an issuer may require an agreement that precludes any securityholder from using the exemption to force it to become a reporting issuer under part 4. Selling securityholders who do not wish to file a prospectus are, therefore, more likely to turn to an exemption in section 6.01 or 6.02 with regard to the securities of non-reporting issuers and to section 6.04 with regard to securities of other issuers.

The equivalent exemption in the new Ontario act requires a limited offering to be completed within a six-month period⁵¹ while the *ALI Code*, s. 242(b), does not specify any period. The Draft Act leaves the period to be specified by the Commission in regulations. The Commission is similarly authorized under subsection (4) to make regulations imposing any other conditions it considers necessary for a limited offering. It may, for example, establish condi-

48 Cf. section 6.02.

49 See ALI FEDERAL SECURITIES CODE, s. 242(b)(1)(B).

50 See subsection (3).

51 See Ontario Securities Act, 1978, s. 71(1)(p).

tions relating to the fungibility of securities of the same class.⁵² It may also require an issuer or its transfer agent to adopt special procedures for securities distributed in such a manner. But if it does not do so, questions of transfer and registration are left to the applicable parts of the corporations acts.⁵³

Similarly, the Commission may by regulation alter the holding period required under paragraph (2)(a) for securities of specified types of issuers, for example, by reducing the period for securities issued by reporting issuers.⁵⁴ It is likely that the Commission will make the period under this section consistent with the holding period under paragraph 2.17(b).

It is worth mentioning that the limited offering exemption does not alter the treatment of securityholders of non-reporting issuers. A resale of a security purchased from such an issuer in a limited offering, even after the three-year holding period, remains a distribution within paragraph 2.17(b), and the selling securityholder must either file a prospectus or find an exemption under part 6 that applies to the sale of his securities.

Section 6.04

Section 6.04 permits securities of a reporting issuer to be sold into the market without a prospectus being filed in limited amounts so that the market for the security is not subjected to substantial pressure. The exemption derives from the *ALI Federal Securities Code*, s. 242(c), and is intended to enable securityholders to sell small amounts of their securities where information about the issuer is publicly available. The section should facilitate the acquisition of capital by reporting issuers from sophisticated purchasers who may use this exemption or the exemptions in sections 6.01 and 6.02. The Draft Act extends the provision to include sales by issuers.⁵⁵ There is little reason to distinguish between an issuer and its insiders in such circumstances, especially as the insider trading provisions in parts 12 and 13 are applicable to such transactions.⁵⁶

Reporting issuers are required to keep their file with the Commission up-to-date and to supply the Commission, their securityholders and therefore the investing public with regular and

52 See e.g. *ALI FEDERAL SECURITIES CODE*, s. 242(b)(8).

53 See e.g. *Canada Business Corporations Act*, pt. VI; cf. *ALI FEDERAL SECURITIES CODE*, ss. 242(b)(5), (6).

54 See e.g. *ALI FEDERAL SECURITIES CODE*, s. 242(b)(2) (period one year for reporting issuer).

55 Cf. *Manitoba Securities Act*, s. 19(1)(2); *Ontario Securities Act*, 1978, s. 71(1)(b); and cf. paragraph 6.01(h) and Commentary.

56 See also, *Grover & Baillie* at n. 341.

timely information concerning their activities.⁵⁷ Moreover, given the threshold figure of 300 equity securityholders for registration under section 4.02, it is unlikely that an active trading market will exist in securities of smaller issuers with sufficient depth to absorb easily securities leaked by an issuer, its insiders or sophisticated purchasers. Because it is questionable whether the exemption should be open to such an issuer and its insiders immediately upon registration, when the market in its securities is likely to be thin and before financial analysts have begun to follow it, the Draft Act incorporates in section 6.04 the concept of the one-year registrant.⁵⁸ The Commission is, however, empowered to alter the period in respect of various classes of reporting issuer.⁵⁹

Because the exemption is intended to apply to open market sales that do not disturb orderly market processes, all trades pursuant to it must be made through a registrant who performs only the functions he customarily performs in connection with a normal trade with or on behalf of any client.⁶⁰ And to ensure that the provision may not be used to make a full distribution to the public without prospectus disclosure, the Commission is authorized under paragraph (2)(c) to make regulations defining the period during which the trading transaction exemption is available and establishing the maximum numbers of securities that may be sold.⁶¹

Section 6.04 grants a rather novel power to the Commission. Subsection (3) authorizes it to require an issuer to file and disseminate information where it believes that the use of the exemption has created such trading activity in a security that further information is necessary for the protection of investors.⁶² The Commission may use this power in the place of or in conjunction with a cease trading order under section 14.04. It may, subject to the review provisions in part 15, require the equivalent of prospectus disclosure or reduce the figures normally applicable under subsection (2). The exercise of either of these powers is complemented by the reporting requirements under subsections 6.02(4) and (5). And the Commission may also, under section 3.04, deny the exemption completely.

57 See parts 4, 7.

58 See ALI FEDERAL SECURITIES CODE, s. 299.16; and see paragraph (2)(a).

59 Cf. paragraph 2.17(b) and Commentary.

60 See paragraph (2)(b).

61 Cf. OSC Policy No. 3-18, 2 CCH CAN. SEC. L. REP. ¶ 54-912 (restrictions on resale).

62 See, *Grover & Baillie* following n. 344.

Section 6.05

This section is the second of the two provisions in the Draft Act designed to avoid any conflict with the power of a province to establish standards for distributions of securities to its residents. Section 5.10 requires the Commission to accept a prospectus filed in connection with an interprovincial distribution for use in any province that has accepted it. Section 6.05 complements the earlier provision by exempting intraprovincial distributions completely.⁶³ The latter section is also related to section 16.01, which for constitutional purposes limits the application of the whole of the Draft Act to matters of transprovincial significance by excluding from its coverage transactions made otherwise than through a stock exchange and entirely in a single province.⁶⁴

The exemption in section 6.05, however, is broader than constitutional considerations alone require. As Parliament has legislative jurisdiction over interprovincial transactions, it could make part 5 applicable to a distribution made wholly in Alberta by an issuer incorporated or resident in Manitoba. Because the securities must first be issued in the province of incorporation, an essential element of the trades would occur outside Alberta and the distribution would be interprovincial.⁶⁵ Similarly Parliament could require a federal corporation to file and deliver a prospectus regardless of where it distributes its securities.⁶⁶ The exercise by Parliament of its complete legislative jurisdiction would lead, however, to anomalous results. For example, a Manitoba corporation carrying on business primarily in Alberta would have to file a prospectus under part 5 if it distributed its securities exclusively in the latter province but not if it did so in Manitoba, even though the proceeds of the distribution were to be used in Alberta; and a federal corporation with its head office and its business in Alberta would never come within the exemption although an Alberta corporation in exactly the same position would. In both types of transaction the availability of the exemption would be arbitrary to the extent that it would treat differently distributions that are essentially identical in all but constitutional terms.

The Draft Act exempts all distributions that are made in a single province in order to avoid any such anomalies, as well as to further the policy of enabling a province to establish the level of protection for its own investors where only they are directly affected. The exemption thus omits a number of requirements

63 See section 5.10, Commentary; and see, *Grover & Baillie* following n. 185.

64 See section 16.01 and Commentary.

65 See, *Anisman & Hogg* following n. 135.

66 See *id.* at nn. 77-82a.

included in the source provisions, such as the condition that the issuer carry on business primarily in the jurisdiction in which the distribution is made.⁶⁷ The provision also differs from the *ALI Code* in requiring that a distribution occur completely in the province. In fact, because of the extended meaning of “sale” under section 2.40, it corresponds to present U.S. law and precludes offers or other similar activities outside of the province in which the distribution is made.⁶⁸

Section 6.05 differs from the source provisions as well in omitting the requirement that all of the purchasers be residents of the province in which a distribution is made. The residence requirement under the U.S. Securities Act of 1933 has led to a number of difficulties, not the least of which is the loss of the intrastate exemption where a security is inadvertently sold to a nonresident, even if the sale occurred in the state in which the distribution is made.⁶⁹ The Draft Act omits the residence requirement in order to avoid these difficulties of definition and application. As a result, a sale of a security in an intraprovincial distribution to a person who does not reside in the province does not deprive the issuer or selling securityholder of the exemption in section 6.05 so long as it takes place within the province. Such a purchaser will receive the same protection as any other purchaser in that province. And the issuer or underwriter cannot solicit purchasers from outside of the province because such solicitations would be “sales” and would result in the loss of the exemption.

Some difficulties will inevitably occur where a distribution is made in a city bordering on another province, for example, in Ottawa, as residents of the neighbouring province are likely to be affected by the sales effort. In such circumstances the exemption simply may not be available. Nevertheless, the Commission will probably develop policies and regulations to deal with such cases pursuant to its powers to grant and deny exemptions under sections 3.03 and 3.04.

The intraprovincial exemption is exclusive; it cannot be used in conjunction with a limited offering under section 6.03 or a distribution to sophisticated purchasers under subsection 6.02(2) to make an interprovincial distribution. However, if an issuer attempts to make a distribution under one of those provisions, as well as under section 6.05, it will be necessary to determine whether the distributions are separate or one, that is, whether the various sales should be integrated and treated as a single distribu-

67 See e.g. *ALI FEDERAL SECURITIES CODE*, s. 514(a)(2).

68 See Securities Act of 1933, s. 3(a)(11) and Rule 147(d), thereunder.

69 See e.g. 1 L. Loss at 592-93; see also *id.* at 595-600.

tion.⁷⁰ The Draft Act leaves this issue too for the development of policies in light of the Commission's experience.

Finally, it is worth reiterating that the anti-fraud provisions of parts 12, 13 and 14 continue to apply to "intraprovincial distributions" that are not excluded from the Draft Act's coverage by section 16.01.

70 Cf. 1 L. Loss at 593.

Part 7

Reporting Issuer Disclosure

Part 7 rounds out the disclosure scheme of the Draft Act by requiring reporting issuers to make regular and timely reports to their securityholders and to the Commission and by imposing on such issuers and their insiders disclosure duties in connection with special types of transactions. The matters dealt with have in the past decade been the subject of much attention in Canada and elsewhere.¹

Part 7 must be viewed in relation to part 4. The earlier Part requires the filing of a registration statement by means of which an issuer acquires reporting status but does not create obligations for regular or timely disclosure of information. Once a registration statement has been filed, part 4 merely requires that it be annually updated.² Part 7 complements these provisions by imposing an obligation on issuers, once registered, to send annual and quarterly reports to their securityholders, to issue press releases when material facts occur and to file all such reports and releases with the Commission.³ The Part deals similarly with securityholder meetings of reporting issuers by making the solicitation of proxies and accompanying disclosure of relevant information mandatory.⁴

1 See e.g. PORTER REPORT; KIMBER REPORT; WHEAT REPORT; ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT; BUSINESS CORPORATIONS PROPOSALS.

2 See section 4.04.

3 See part 7A.

4 See part 7B.

Thus parts 4 and 7 together form the basis of the continuous disclosure system in the Draft Act. The registration statement filed under part 4 is intended to contain both hard and soft data of the type useful to investment analysts and other securities professionals, while the information actually disseminated to securityholders is to be in a form readily understandable to a layman.⁵ The reports and proxy circulars required under this Part fall into the latter category. On the whole they should be short, straightforward and non-technical. The Draft Act does not, however, preclude the inclusion of technical data in reports to securityholders; on occasion detailed information may be necessary to their decision-making. Rather, it leaves the integration of the type of disclosure required in the various documents to the Commission's power to make regulations. In this regard the Draft Act follows the approach of the Canada Business Corporations Act.⁶

Part 7 also requires disclosure of information in connection with specific types of transactions that may influence or necessitate investment decision-making. Thus it includes the Draft Act's insider reporting provisions so that securityholders may obtain information about the ownership and management of reporting issuers, and it also regulates the conduct of takeover bids to ensure that securityholders have both the time and the information necessary to determine whether to accept a bid without being subjected to unfair pressures.⁷

As the Canada Business Corporations Act contains the most recent embodiment of federal legislative policy on all of these subjects, the Draft Act tends to follow its provisions. And as at present, the Commission is not required to vet the disclosure documents required under part 7, for such a requirement would impose a substantial administrative burden.⁸

A number of minor variations from the provisions of the Canada Business Corporations Act are made necessary by the different definitions and structure of the Draft Act and by the fact that its general policy objective relates to market regulation.⁹ The Draft Act's general market orientation has also led to a few more significant alterations, primarily in connection with reporting of transactions in the securities of reporting issuers. Part 7C requires a person who purchases sufficient securities to become an insider of a reporting issuer to file an insider report within three business days of their acquisition in order to warn

5 See part 4, Commentary.

6 See BUSINESS CORPORATIONS PROPOSALS, ¶¶ 14, 506-07.

7 See parts 7C, 7D.

8 See e.g. *Grover & Baillie* at n. 325 and following.

9 See e.g. section 7.02; compare Canada Business Corporations Act, s. 154(4).

investors of a possible change in control or management¹⁰ and integrates this requirement with the general insider reporting provisions.¹¹ At the other extreme, the Draft Act requires the Commission to establish specific criteria for a *de minimis* exemption from part 7C to avoid unnecessary paperwork for insignificant transactions.¹² It is expected that such an exemption will make the published data concerning trading by insiders more readily accessible to analysts and investors.¹³

Part 7A Continuous Disclosure

Sections 7.01 and 7.02

Part 7A complements part 4 by ensuring that information about current developments relating to reporting issuers is made available to securityholders and other investors in a manner that is understandable to them. The complementarity of the annual report and the registration statement is emphasized by the fact that the latter document and the annual amendments to it must be filed by the end of the period within which an annual report is required to be sent to securityholders and filed with the Commission under section 7.01.¹⁴ An issuer may therefore prepare both documents simultaneously as of its financial year end and, if a corporation, at the same time as it is preparing for its annual meeting.¹⁵ Indeed, the Commission's efforts at integrating the disclosure provisions of parts 4 and 7 are expected to encompass not only the registration statement and annual report but also the annual proxy circular sent to securityholders in connection with the annual meeting.¹⁶ The Commission may thus through its regulation-making powers simplify the disclosure burden of issuers and increase the utility of documents circulated to securityholders. In doing so, the Commission is expected to take into account as well the various reporting requirements relating to annual meetings under the corporations acts.

Although financial statements are often difficult for lay investors to understand, especially in light of the broad discretion often available under generally accepted accounting principles, it

10 See, Yontef, ch. II.D.

11 See sections 7.12-7.14 and Commentary.

12 See section 7.17 and Commentary.

13 See e.g. Anisman at 200-01.

14 See subsections 4.02(2), 4.04(2).

15 See e.g. Canada Business Corporations Act, s. 127.

16 See section 7.05; and see, Grover & Baillie at n. 324.

is not expected that financial statements will be excluded from reports sent to securityholders. In fact, the periods specified in sections 7.01 and 7.02 for the preparation of annual and quarterly reports coincide substantially with the periods during which issuers' financial statements are usually prepared. While the Commission will undoubtedly review the distribution of financial information between reports under part 7 and the registration statement, it is likely to continue to require financial statements in the former types of reports for some time, especially as they are now so required under the provincial corporate and securities laws.¹⁷

The period for preparation of an annual report under the Draft Act is somewhat shorter than under the Canadian source provisions. However, the ninety-day period is clearly feasible and will ensure that securityholders receive information on a more timely basis.¹⁸ Some reduction is necessary in any event if quarterly reports are required, as is evident from the new Ontario act.¹⁹ (The present Ontario act requires only semi-annual reports while the 1978 act demands quarterlies.²⁰) The dissemination of quarterly reports under section 7.02 is also more timely than under the source provisions, and the Commission is likely to encourage issuers to increase the amount of narrative description that accompanies the unaudited financial statements currently contained in them.

The provincial securities acts require only that annual and interim financial reports be filed with the commissions.²¹ The corporations acts, however, ensure that the annual report is sent to shareholders and the Ontario Securities Act, 1978, requires that all reports be sent to securityholders who own other than debt securities.²² The Draft Act varies slightly from the source provisions in requiring that a reporting issuer send its annual report to all of its securityholders but permitting the quarterly reports to be sent only to shareholders, that is, in allowing an issuer to refrain from sending them to holders of debt securities.²³ This distinction is based on a conclusion that the need of holders of debt securities for information concerning their issuer is less than that of shareholders and that it may therefore be met on an annual basis. Should

17 See e.g. Ontario Securities Act, pt. XII; and see, *Grover & Baillie* following n. 322.

18 See, *Grover & Baillie* at n. 321.

19 Compare e.g. Ontario Securities Act, s. 120 (170 days) and Ontario Securities Act, 1978, s. 77 (140 days).

20 See Ontario Securities Act, s. 130; Ontario Securities Act, 1978, s. 76.

21 See e.g. Ontario Securities Act, ss. 120, 130, 131.

22 See e.g. Canada Business Corporations Act, s. 153; Ontario Securities Act, 1978, s. 78; cf. ALI FEDERAL SECURITIES CODE, s. 602(a)(2).

23 See section 7.02.

a debtholder wish more timely information, he may obtain it from the Commission's files at no extra cost to the issuer.

The Draft Act makes clear that an issuer may include in a report to securityholders supplementary information not required by the regulations unless the Commission by regulation has prohibited it. While it is unlikely that the Commission will exercise its prohibitive powers frequently, it may do so in relation to certain types of "soft" information, such as speculative forecasts, that are difficult to understand or interpret.

Section 7.03

Timely disclosure of new developments by corporate issuers has long been accepted in the securities market as necessary for the protection of investors.²⁴ The common method of disseminating such information, the press release, is adopted by section 7.03 along with the additional requirement that a copy be filed in order to facilitate the Commission's enforcement capabilities and to ensure that the Commission's files on reporting issuers are current.

There may be circumstances, however, in which immediate disclosure of material information would be detrimental to an issuer. For example, a proposed takeover bid or pending merger may be aborted if information concerning it is prematurely made public.²⁵ In such circumstances a rigid requirement that a press release be issued would likely result in harm not only to the issuer but also to its securityholders whom the provision is intended to protect. The Draft Act therefore permits an issuer not to comply with the section where disclosure would be "unduly prejudicial" to its business or affairs.

This exception creates further difficulties, for it is precisely in the cases in which the exception applies that the danger of insider trading is greatest and that the Commission's surveillance of the market activity in its securities is most important.²⁶ As a result, the Ontario Securities Commission adopted a policy in 1971 requiring issuers to inform it of all such material developments by telephone on a confidential basis so that it can monitor the market in the issuer's securities and stop trading if there is unexplained

24 See e.g. Uniform Act Policy No. 2-12, 2 CCH CAN. SEC. L. REP., ¶54-882 ("Timely Disclosure" December 6, 1971); TORONTO STOCK EXCHANGE, MEMBERS' MANUAL at G1 (December 9, 1968); and see P. ANISMAN at 127-28, n. 313.

25 See also, *Grover & Baillie* following n. 158.

26 See e.g. *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

activity.²⁷ The policy is incorporated in the new Ontario legislation and has apparently been accepted by all of the Canadian administrators.²⁸

The Draft Act adopts a compromise solution that accommodates the Commission's need to know of the existence of undisclosed material information relating to an issuer so that it may increase its surveillance of trading in the issuer's securities, without requiring the issuer to disclose the information itself.²⁹ The Commission is thus enabled to focus its enforcement activities; but it must keep even the fact of having received the notice confidential.³⁰ In fact the wording of the section itself implicitly indicates the need for confidentiality. A notice is "sent to" rather than "filed with" the Commission and thus is not included on the issuer's public file. Having sent such a notice, an issuer must issue and file a press release as soon as compliance with subsection (1) would not unduly prejudice it (paragraph (2)(a)) or, if the transaction falls through so that the fact ceases to be material, it must file a notice to that effect with the Commission. A notice filed pursuant to paragraph (2)(b) thus becomes public and is available to securityholders.

The initial determination of whether disclosure of a material fact would be unduly prejudicial is for the issuer, and as it need not disclose the fact in a notice under subsection (2), its conclusion cannot be questioned by the Commission. Nevertheless, an issuer's decision should not be final. Once the information is disclosed under paragraph (2)(a) or a notice is filed under paragraph (2)(b), the Commission may investigate to determine whether the information actually met the required standard. If it did not, the Commission may take remedial measures under part 14.

Part 7B

Proxy Solicitation

Legislation regulating the solicitation of proxies was first enacted in Canada in 1966, following the recommendations of the Kimber Committee, to ensure that securityholders of public issuers receive sufficient information to be able to exercise their votes in a rational manner.³¹ The legislation, which was based on

27 See Ontario Policy No. 3-23, 2 CCH CAN. SEC. L. REP. ¶54-917 ("Administration: Timely Disclosure Policy" December 6, 1971).

28 See Ontario Securities Act, 1978, s. 74.

29 See subsection (2) (notice of the existence of a material fact); and see, *Grover & Baillie* at nn. 326-27.

30 See subsection (3).

31 See Securities Act, 1966, S.O. 1966, c. 142, pt. X; KIMBER REPORT, pt. VI; and see PORTER REPORT at 352.

the proxy rules under the U.S. Securities Exchange Act of 1934, has since been adopted in five other provinces and by Parliament in its corporations laws, and there has been a substantial amount of written commentary on the subject in Canada and elsewhere.³² The proxy provisions of the Canada Business Corporations Act represent the most recent expression of federal policy in this area. As the Draft Act tends to follow the approach of that act, it is unnecessary to discuss in detail the reasons for all of its provisions; rather the Commentary deals with the differences in approach and substance necessitated by the market orientation of the Draft Act.

The difference between corporation law and securities regulation is frequently asserted as a basis for determining where particular provisions should be enacted.³³ The dividing line between the two types of legislation, however, is far from clear, especially in relation to matters such as periodic reporting, insider trading, takeover bids and proxies which directly affect internal corporate relationships and investor protection as well as the confidence of investors in the fair operation of the securities market.³⁴ Because the annual solicitation of proxies by management is a necessary element of the annual meeting of securityholders required to be held by corporate issuers, the proxy circular is an important part of any disclosure system. It and the annual report are the two documents that are required to be sent to all equity securityholders and that together should form the foundation for disclosure to investors.³⁵ It is expected that the Commission will, through its power to prescribe the contents of the various disclosure documents, require coordination of the information in the management proxy circular and the annual report, possibly in summary form so that it is comprehensible to securityholders, and will relegate supplementary and more technical information to the registration statement.

Despite the substantial overlap between the aims of corporate and securities legislation in this area, some line drawing is inevitable. Part 7B focuses on the elements of the proxy process that affect investors most directly, namely, the solicitation and disclosure process, and leaves matters relating to the calling and conduct of meetings to the corporations acts, which establish the

32 See e.g. 1 BUSINESS CORPORATIONS PROPOSALS, pt. 12; J. WILLIAMSON, SUPP. ch. 15; Getz, *The Alberta Proxy Legislation: Borrowed Variations on an Eighteenth Century Theme*, 8 ALTA. L. REV. 18 (1970); E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL (2d ed. 1968).

33 See e.g. ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT, ¶¶2.17, 2.40.

34 See e.g. *Anisman* at 155-57.

35 Cf. e.g. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, s. 601, Comment (2)(a).

constitutional framework of corporate issuers, and to the organizational agreements of other issuers. Thus section 7.07, while adopting the provisions of the Business Corporations Act dealing with the execution, validity and revocation of proxies in order to ensure their applicability to unincorporated issuers, does not include the section authorizing securityholders to appoint a proxyholder to exercise their vote.³⁶ For similar reasons the Draft Act does not deal with shareholder proposals.³⁷ Section 7.05, continuing the recommendation in the *Kimber Report*,³⁸ makes mandatory the solicitation of proxies in connection with meetings of securityholders of reporting issuers without itself creating a duty to call meetings. And section 7.08 requires a proxyholder to attend the meeting in respect of which he receives a proxy and to vote the securities in accordance with his instructions. Although both of these requirements could be said to relate as much to the internal affairs of issuers as to the needs of investors, they are included in the Draft Act because they are essential to the fair operation of the proxy solicitation process.

Section 7.04

A number of technical comments in relation to specific provisions of part 7B are important to an understanding of the Part. Section 7.04 contains the definitions applicable to the Part and is taken almost verbatim from the Canada Business Corporations Act, s. 141. One alteration has been made, however, in the definition of "solicitation". The Canada Business Corporations Act, s. 141, includes as a solicitation the sending of a form of proxy to a securityholder by the issuer's management as required by section 143, the source for section 7.05. As section 7.05 expressly requires that the directors send a form of proxy whenever they send a notice of a meeting and as the sending of such a form is a solicitation within subparagraph 7.04(c)(iii), the provision expressly declaring it to be a solicitation is redundant and is not included in the Draft Act.

Section 7.05 requires the directors of a reporting issuer, rather than its management, to solicit proxies when calling a meeting.³⁹ As the Draft Act contains no definition of "management" and as a "solicitation by the management of an issuer" is defined in paragraph 7.04(d) in terms of directors' supervision or

36 See Canada Business Corporations Act, s. 142.

37 Cf. *id.* s. 131; and see generally Getz, *The Structure of Shareholder Democracy*, in 2 STUDIES IN CANADIAN COMPANY LAW 239 (J. Ziegel, ed. 1973).

38 See KIMBER REPORT, ¶6.24.

39 Compare Canada Business Corporations Act, s. 143(1).

acquiescence, the duty is more appropriately imposed upon the issuer's governing body.

Section 7.09

Section 7.09 is included to ensure the integrity of the proxy process by precluding a registrant from voting securities registered in his name and held by him for his clients unless he obtains their approval. The Canada Business Corporations Act, s. 147, and the Ontario Securities Act, s. 80, merely prohibit a registrant from voting the securities held by him as nominee. The Ontario Securities Act, 1978, goes further and requires a registrant to send the materials to the beneficial owner of the securities to which they relate if the issuer or the client has agreed to pay the costs incurred in doing so.⁴⁰ While section 7.09 is closer to the former provisions, the Draft Act as a whole is closer to the new Ontario act. Section 11.05 generalizes the duty imposed by the new Ontario act and makes it applicable to all documents sent to securityholders.⁴¹ And paragraph 7.09(a) incorporates the requirements of section 11.05 by reference. As a result, it is clear that the voting of securities in violation of section 7.09 is improper, and such votes are therefore not to be counted.⁴²

Section 7.10

Section 7.10 exempts from the proxy provisions three types of solicitation; the first derives from the Canadian source provisions and the latter two from the *ALI Code*. Paragraph (a) is included in the Draft Act, as in the provincial legislation, to permit securityholders to discuss their issuer's affairs and to form securityholder groups to oppose management policies without having to comply with the proxy provisions.⁴³ A failure to include this exemption might deter the formation of such groups by forcing them to publicize their activities prematurely or suffer the consequences of violating the Draft Act. When they seek the support of other securityholders, however, they must comply with part 7B; the proxy provisions always apply when a general solicitation is made by a dissident group.

Paragraph (b) accommodates the needs of offerors by permit-

40 Ontario Securities Act, 1978, s. 48(2).

41 See section 11.05, Commentary.

42 Cf. *Murphy v. Lindzon*, [1969] 1 O.R. 631, *reversed*, [1969] 2 O.R. 704 (C.A.) (without deciding issue).

43 See e.g. Getz, *supra* note 32, at 29; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, s. 602(i)(11), Comment.

ting them to request a proxy with the deposit of securities certificates pursuant to their takeover bids. The practice is common in the United States, but not in Canada, and enables an offeror to combat defensive tactics, such as a proposed charter amendment or merger, that involve a vote of securityholders.⁴⁴ The paragraph precludes abuse of the exemption by permitting the proxy to be used only where the offeror has purchased the securities deposited in the bid, or at least where his conditions have been met and he is bound to do so.⁴⁵ The provision thus ensures that securityholders receive the disclosure required in the takeover bid circular and that an offeror may vote the purchased securities without the delay otherwise required to make a solicitation in compliance with this Part to obtain proxies from the registered offerees.

Finally, paragraph (c) permits solicitations of securityholders in connection with a derivative action or a bankruptcy where the supervision of a court is likely to ensure disclosure of necessary information so that compliance with the proxy provisions would involve unjustifiable expenditures.⁴⁶ And, of course, the Commission may under section 3.03 grant any further exemptions it considers appropriate either in individual cases or by regulation.

Part 7C

Insider Reporting

Reporting of trading by insiders in the securities of their corporations was initially required in Canada to deter abuse by them of their positions through use of confidential information. This approach was adopted by the Kimber Committee and forms the basis of the reporting requirements added to the provincial securities acts since 1966.⁴⁷ Subsequently, however, the insider reporting provisions of several jurisdictions were extended to require accelerated reporting by persons who accumulate large amounts of an issuer's securities, so that investors may learn quickly of a potential new influence on the issuer's management and adjust their investment decisions accordingly,⁴⁸ and the newer policy has been adopted in several of the provincial securities acts.⁴⁹

The Draft Act continues the Brandeisian policy of requiring disclosure of transactions by insiders in order to facilitate enforce-

44 See P. ANISMAN at 260 n. 90.

45 See *id.*; cf. ALI FEDERAL SECURITIES CODE, s. 603(i)(7).

46 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, ss. 602(i)(5), (8) and Comments.

47 See KIMBER REPORT, pt. II; *Anisman* at 173-81; *Yontef* at nn. 11-12.

48 See e.g. Securities Exchange Act of 1934, s. 13(d).

49 See e.g. Ontario Securities Act, s. 110(a); and see P. ANISMAN at 108-15.

ment of an insider's fiduciary duty not to make improper use of information. As with the earlier provisions of this Part, it largely follows the Canada Business Corporations Act as amended in 1978. However, because of the market orientation of the Draft Act and the importance to investors of potential changes in the control of an issuer, the reporting requirements are extended to require accelerated reporting by persons who become insiders through the acquisition of securities. Part 7C therefore attempts to integrate accelerated and regular reporting by insiders in a consistent scheme.⁵⁰

Part 7C contains one further provision that is new to Canada. At present insiders are required to report to the provincial commissions and to the federal Director of Corporations all changes in their holdings during a given month, and the information contained in their reports is published in the periodicals released by the various regulatory bodies. As a result a large number of relatively minor transactions must be reported and the publications released by the commissions are large, often difficult to decipher, and have been the subject of criticism.⁵¹ The Draft Act therefore adopts a "small trade" exemption and requires the Commission to specify its limits.⁵² The exemption should reduce the volume of insider reports without unduly detracting from the deterrent purpose of the Part and without depriving securityholders of the possibility of discovering whether insiders of their issuer traded at a time when confidential information existed. Similarly the Draft Act does not require the Commission to publish the information contained in insider reports.⁵³ Rather it authorizes the Commission to publish in a periodical the information it considers of value to investors.⁵⁴

Section 7.11

Section 7.11 contains the definitions applicable to part 7C and follows in substance the Canada Business Corporations Act as modified by the recent amendments. As these provisions have been discussed elsewhere, detailed comment is not necessary here.⁵⁵ However, the section contains one important change; paragraph (2)(e) declares that an insider owns beneficially securities

⁵⁰ See section 7.13 and Commentary.

⁵¹ See e.g. *Yontef* following n. 70.

⁵² See section 7.17 and Commentary.

⁵³ Cf. Canada Business Corporations Act, s. 123.

⁵⁴ See subsection 15.11(5).

⁵⁵ See 1 BUSINESS CORPORATIONS PROPOSALS, ¶¶ 256-58; *Anisman* at 181-201; *Yontef*, ch. II.

owned by his associates. The provision is included to require insiders to report on securities owned by their associates in order to prevent evasion of the reporting requirements by purchasing securities through a family member or close business associate.⁵⁶ Similar requirements have long existed under the U.S. legislation and under the British Columbia Act.⁵⁷ The Draft Act utilizes the presumptive approach of paragraph (2)(e) rather than including associates within the definition of "insider" in order to avoid the extension of the reporting requirements that would result from the other provisions of subsection (2) and also to make clear that the duty to report is on the insider rather than on his associates. It is expected that the Commission will require him to report only the trades of associates of which he is aware.

Sections 7.12, 7.13 and 7.14

Sections 7.12 to 7.14 require insiders to file initial insider reports and reports of any changes in their holdings. The first section imposes a duty to report on persons who are insiders when an issuer files a registration statement, that is, when it becomes a reporting issuer, and on persons who become insiders thereafter by accepting a position as an officer or director of the issuer. The section applies as well to issuers that trade in their own or their affiliates' securities and to presumed insiders as a result of an acquisition or other business combination. Initial reports by persons who become insiders under paragraph 7.11(1)(d) by acquiring 10% of an issuer's equity securities must be filed within three days and further reports must be made with similar speed each time such an insider acquires a further 5% of the securities.⁵⁸

The Draft Act adopts a 10% figure for initial reporting by persons within paragraph 7.11(1)(d), primarily to harmonize it with the current Canadian insider reporting requirements. The figure in similar legislation in the United States and in the United Kingdom is 5%.⁵⁹ While the three-day requirement corresponds to the timing of accelerated insider reports under the provincial acts, the provincial legislation requires such reporting only by persons who acquire 20% of an issuer's securities.⁶⁰ The 10% figure in the Draft Act takes into account the thinness of the Canadian securi-

56 See section 2.04 ("associate") and Commentary; and see, *Yontef* at nn. 52-53.

57 See e.g. Rule 16a-8 under the Securities Exchange Act of 1934; British Columbia Securities Act, s. 106(1)(c) ("insider").

58 See section 7.13.

59 See Securities Exchange Act of 1934, s.13(d) (ten days); Companies Act 1976, 24 Eliz. II, c. 69, s. 26 (1976) (five days); and see ALI FEDERAL SECURITIES CODE, ss. 605(a)(4), 605(b).

60 See e.g. Ontario Securities Act, 1978, s. 103.

ties market as compared to those in the United States and Britain.⁶¹

One purpose of the accelerated reporting requirements adopted elsewhere is to warn an issuer's management of warehousing that may precede an attempt to acquire control of the issuer. The principal purpose of section 7.13, however, is to provide investors with information, not to provide corporate management with a defensive tool for use against potential acquirers or insurgents. It thus reflects the more recent approach of the U.S. courts.⁶²

The scheme of part 7C is as follows. Directors and officers of a reporting issuer and presumed insiders under subsection 7.11(3) are required to file an insider report within ten days after the end of the month in which they become insiders, and they and the issuer itself have to file similar reports within ten days after the end of a month in which they engage in trades in the issuer's securities that are not within the small trade exemption.⁶³ Persons who become insiders by virtue of their securities holdings must file their initial report within three days of their acquisition of the securities or of control or direction over the requisite number of votes and must file a similar report within three days after their interest increases by 5%.⁶⁴ Thus they must file on an accelerated basis when they reach the 10% level and again when they reach the 15%, 20% and 25% levels. Such insiders must also file reports of other lesser changes in their holdings within ten days after the end of the month in which the change occurs.⁶⁵

There has been much concern expressed about the requirement that "nil" reports be filed. Although part 7C does not expressly deal with this question, the Commission is authorized to create exemptions under the general power in section 3.03 and it is likely, initially at least, to follow the approach adopted by other Canadian administrators.⁶⁶

Similarly, the Draft Act leaves to the Commission the contents of insider reports so that it may harmonize the various initial and subsequent reports required under the Part. Nevertheless, it is expected that information like that required under the source provisions will be prescribed.⁶⁷

61 Cf. P. ANISMAN at 31-33.

62 See *Rondeau v. Mosinee Paper Corp.*, 95 S. Ct. 2049 (U.S.S.C. 1975).

63 See sections 7.14, 7.17.

64 See section 7.13.

65 See section 7.14.

66 See also section 7.16; and see, *Anisman* at 196; *Yontef* at nn. 52-53.

67 See e.g. Canada Business Corporations Act, s. 122(7); Ontario Securities Act, 1978, s. 102(2).

Section 7.15

Because evasion of the insider reporting requirements may be easily concealed through the use of nominee accounts, some method of enforcement beyond the Commission's normal investigative powers to detect such violations is virtually essential.⁶⁸ Section 7.15 is an attempt to achieve this end by requiring any person in whose name securities are registered, that is, any nominee, to report to the Commission a known failure by the beneficial owner of the securities to comply with part 7C. The provision derives from the new Ontario act, the original version of which imposed the duty to report on nominees who know or should know of the insider's violation.⁶⁹ Because of the due diligence standard in the words "should know", the section originally excepted lenders that take securities from an insider as collateral for a *bona fide* debt. The exception was necessary because without it the effect of the section was to impose a duty to investigate on banks and other lenders that probably would have impeded normal commercial transactions. However, the Ontario act as enacted retains the exception even though it has deleted the due diligence standard.⁷⁰ As the duty to report under section 7.15 is based upon actual knowledge of a failure to file by an insider, the Draft Act omits the exception as well. There can be little interference with normal commercial transactions and little excuse for a failure to report when a lender actually knows of a violation.

Section 7.17

As mentioned above, commentators have stated that a large number of reports filed by insiders relate to insignificant transactions. The Draft Act, in response to such criticism, creates an exemption from the reporting requirements for small transactions by insiders. The precise details of such an exemption, however, are not easily determined. It has been suggested that it include trades involving as much as \$10,000 or \$15,000.⁷¹ On the other hand, a similar exemption promulgated by the Securities and Exchange Commission is available only for acquisitions of securities having a value no greater than \$3,000 during any six-month period.⁷² It has also been suggested that a small transaction exemption could be based on a percentage of the holdings of the

68 See e.g. *SEC v. General Refractories Co.*, 400 F. Supp. 1248 (D.C.D.C. 1975).

69 See Ontario Bill 7 (2d reading), s. 105.

70 See Ontario Securities Act, 1978, s. 105.

71 See, *Yontefat* n. 72.

72 See Rule 16a-9 under the Securities Exchange Act of 1934.

insider or on a specified number of securities. In short, a large number of alternative approaches to defining a “small transaction” are possible, any one of which may include trades that are significant to an insider although not to the market and vice versa. As the selection of criteria must depend on factors such as the depth of the market and the breadth of holdings in a specific security, the Draft Act requires the Commission to define the exemption’s limits in the light of its empirical knowledge, including specification of the period during which the trades must occur and the timing of insider reports once a specified level is reached. As subsection (2) is mandatory, it is expected that the Commission will promulgate proposed regulations with dispatch. Until the Commission complies with the subsection, determination of the scope of the exemption is left to case-by-case adjudication before the Commission and the courts.

Section 7.18

A number of provisions in the Draft Act are directed at avoiding conflict with the laws of other jurisdictions where there is substantial compliance with the Draft Act’s requirements. Section 7.18, reflecting the same policy, enables issuers to comply with part 7 by filing copies of documents required to be filed in their home jurisdiction, so long as there is no substantial diminution of the protection provided to investors under the Draft Act. The section is based on the Ontario Securities Act, 1978, and integrates its three provisions into one. The actual form of the filings is left to the Commission’s regulation-making power so that it may require supplementary filings where necessary.

Part 7D

Takeover Bids

Like the legislation requiring continuous disclosure, proxy solicitation and insider reporting, legislation regulating the conduct of takeover bids was first introduced in Canada by the Ontario Securities Act in 1966 and has since been adopted by five other provinces and included in federal corporate legislation.⁷³ The Canadian takeover bid legislation, like that in most English-speaking jurisdictions, is designed to relieve offeree security-holders of the pressures that previously accompanied a bid and to enable them on the basis of full information to make a rational

73 See KIMBER REPORT, pt. III; P. ANISMAN, ch. 1.

decision whether to accept the bid. In short, it is intended to protect offerees without altering the balance of influence between offeree management and takeover bidders. The legislation initially enacted in Canada was influenced by similar legislative schemes elsewhere in the Commonwealth and in its turn influenced the development of statutory regulation of takeover bids in the United States. The experience with the local legislation and with its predecessors and progeny was the subject of substantial comment which was considered in the preparation of the most recent federal legislation on the subject, the Canada Business Corporations Act, part XVI.⁷⁴ The Draft Act therefore largely follows the statutory scheme adopted by Parliament in 1975.

Section 7.19

The definitions in part 7D are virtually identical with those in the Canada Business Corporations Act. Some changes have been made, however, to accommodate the different definitional criteria and scope of the Draft Act. For example, it is not necessary for the Draft Act to exempt an offer relating to an issuer with fewer than fifteen securityholders as, generally, none of the provisions in the act applies to issuers with fewer than fifty securityholders.⁷⁵ Similarly, the definition does not expressly include an offer exempted by the Commission; both this provision and the express power to exempt in the source statute have been omitted in light of the Commission's general power to grant exemptions.⁷⁶ A few other redundancies in the source provisions have also been deleted. Subparagraph (a)(i), for example, no longer requires that offers to fewer than fifteen securityholders be to purchase "by way of separate agreement" because the phrase is ambiguous and might also preclude the purchase of securities from a control group.

Two substantive alterations are included in section 7.19. The Canada Business Corporations Act defines a takeover bid in terms of 10% of the equity securities of an issuer. But because the broad definition of "share" in that act includes rights to acquire a voting security, the percentage is calculated on the basis of all outstanding voting securities *and* rights to acquire them, so that a person might acquire securities carrying over 10% of the votes but still not

74 See e.g. P. ANISMAN; E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* (1973).

75 See paragraph 3.01(e); cf. Canada Business Corporations Act, s. 187 "exempt offer" (c).

76 See section 3.03; cf. Canada Business Corporations Act, s. 187 "exempt offer" (d) and s. 197.

make a "takeover bid".⁷⁷ Paragraph (f) therefore follows the phraseology of the definition of "insider" and includes an offer to purchase equity securities that would result in the offeror controlling "over 10% of the votes attached to equity securities" of the issuer.⁷⁸

As the Draft Act is concerned primarily with the fair operation of the securities market, the definition of "takeover bid" and, therefore, the application of part 7D are limited to reporting issuers.⁷⁹ The limited applicability of the Part reinforces the jurisdictional nexus for section 7.24 which requires offeree directors to send a directors' circular to their securityholders. While a takeover bid for the securities of a non-reporting issuer may require legislative protection for offerees, this area is left to the provincial securities acts under which it is now regulated.⁸⁰

The Draft Act does not attempt to resolve a number of current issues relating to the meaning of "takeover bid" and thus to the coverage of part 7D. Concern has recently been expressed in Canada and elsewhere over the acquisition of control of an issuer by means of private purchases of securities from a controlling securityholder or a control group and by means of purchases in the open market. The latter phenomenon arose in Canada as a result of the development of "stock exchange takeover bids".⁸¹ After much negotiation and discussion the provincial commissions and Parliament ultimately accepted the procedure devised by the stock exchanges to regulate such bids,⁸² and the acceptance was reflected in the Canada Business Corporations Act, s. 187 "exempt offer" (b), and the regulations under it.⁸³ The Draft Act does not attempt to reopen this question.⁸⁴

The sale of a controlling block of securities has been the subject of a substantial debate which is still continuing.⁸⁵ The new Ontario act requires a person who purchases a control block of securities at a premium over the current market price to make an

77 Cf. *Anisman* at 184-85.

78 See *id.* at 185-86; and see paragraph 7.11(1)(d).

79 See paragraph (f); cf. ALI FEDERAL SECURITIES CODE, s. 606(a).

80 See e.g. Ontario Securities Act, s. 81(g); and see Canada Business Corporations Act, s. 187; cf. *P. ANISMAN* at 44-45.

81 See *P. ANISMAN* at 54-55.

82 See e.g. *Anisman & Hogg* at n. 11; and see TORONTO STOCK EXCHANGE, BY-LAWS, pt. XXIII.

83 See Canada Business Corporations Regulations, s. 58.

84 See subparagraph (a)(ii).

85 See e.g. *P. ANISMAN* at 37-40 n. 65, 353; Gibson, *The Sale of Control in Canadian Company Law*, 10 U.B.C. L. REV. 1 (1975); cf. Block and Schwarzfeld, *Curbing the Unregulated Tender Offer*, 6 SEC. REG. L.J. 133 (1978).

equivalent offer to the remaining securityholders.⁸⁶ The impetus for the legislation is the apprehended loss of confidence in the market by investors if such transactions are permitted to occur. But the effects of such legislation are still far from clear.⁸⁷ As a result, the Draft Act takes no position on this question but leaves it for reconsideration in the light of the experience under the Ontario legislation and the comments received on these *Proposals*.

One final matter requires mention. The new Ontario act treats certain repurchases of securities by an issuer like takeover bids and therefore contains a separate definition of "issuer bid".⁸⁸ Although the Draft Act does not include the new definition, the type of transaction is included within the meaning of "takeover bid" in paragraph (f) as it is in the source provision.⁸⁹ Repurchases by issuers by means of a tender offer are thus subject to the same equitable restrictions as a takeover bid by an outsider, and the Commission may devise appropriate disclosure requirements for the takeover bid circular sent in connection with an offer to repurchase.⁹⁰

Sections 7.20 to 7.24

Sections 7.20 to 7.23 set out the substantive provisions applicable to takeover bids and section 7.24 imposes a duty to send a takeover bid circular. Although the sections omit a number of provisions of the Canada Business Corporations Act, they do not alter its substance. Rather, the omitted provisions relate to disclosure requirements and are therefore left to the regulations. For example, the requirement that an offeror disclose whether he intends to invoke a statutory right to compulsorily acquire the securities of a small minority of offerees who do not accept the bid is not included in section 7.21.⁹¹ Finally, the investigative and remedial provisions are omitted from part 7D and included in parts 13 and 14.⁹²

86 See Ontario Securities Act, 1978, ss. 88(1)(e), (k), 91, 129; see also, *Anisman & Hogg* at nn. 71-74b.

87 See e.g. Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHICAGO L. REV. 420 (1965).

88 See Ontario Securities Act, 1978, s. 88(1)(d).

89 See Canada Business Corporations Act, s. 187; cf. ALI FEDERAL SECURITIES CODE, s. 606(a)(2); and see, *Anisman* at 271-72.

90 See e.g. Canada Business Corporations Regulations, s. 63.

91 Cf. Canada Business Corporations Act, s. 188(c).

92 Cf. *id.* ss. 195(2), 198.

Section 7.25

Section 7.25 makes a directors' circular mandatory. It is expected that the Commission will follow the example of the Canada Business Corporations Act and require that directors disclose in a notice sent pursuant to subsection (2) all of the information concerning the offeree issuer that is required to be included in a directors' circular and that is then available. And, of course, information contained in the earlier document need not be repeated when a directors' circular is later sent.⁹³

93 See Canada Business Corporations Regulations, ss. 68, 69.

Part 8

Market Actors

The licensing of persons who trade in securities has been a hallmark of the securities laws throughout North America virtually since their inception.¹ In fact the Canadian laws have, if anything, emphasized this method of providing investor protection. The first Canadian securities legislation, the Manitoba Sale of Shares Act of 1912, contained a requirement that sellers of securities obtain a licence, and the subsequent provincial acts that form the basis of the present legislation were initially directed exclusively at the registration of securities traders.² Although the provincial acts have adopted provisions requiring disclosure by issuers, at least in connection with distributions, all of them still retain a licensing requirement, usually for brokers, dealers, advisers and underwriters.³

The registration scheme in the provincial securities laws relies on a broad definition of "trade" and a prohibition against any person "trading" without a licence as a broker, dealer or salesman.⁴ Underwriters and advisers are similarly required to become registered.⁵ Because the prohibition applies to virtually

1 See e.g. L. LOSS & E. COWETT, BLUE SKY LAW 7, 26-30 (1958); J. WILLIAMSON, SUPP., ch. II; *Connelly*.

2 See e.g. J. WILLIAMSON at 12, 20-28.

3 See e.g. Ontario Securities Act, s. 6; *Connelly*, ch. II.

4 See e.g. Ontario Securities Act, ss. 1(1)24, 6(1)(a); and see D. JOHNSTON at 90-91.

5 See e.g. Ontario Securities Act, ss. 6(1)(d), (e) (persons who "act as" underwriters or advisers).

everyone who trades in – or at least sells – securities, the acts contain a substantial list of exemptions from registration for specific types of security and classes of trades.⁶ The list of exemptions has until recently served double duty, applying in effect to both the licensing and prospectus requirements, but it has been split in the new Ontario act so that the exemptions may be tailored to the different demands of the registration and prospectus requirements.⁷

The intent of the provincial legislation is to ensure that all persons who carry on a business of trading in securities with members of the public meet the standards of competence, honesty and financial stability that are necessary to obtain and retain registration.⁸ The Draft Act, rather than adopting the scheme in the provincial acts, attempts to accomplish the same result by requiring registration only of persons who carry on business as brokers, dealers or advisers or act as underwriters.⁹ This difference in approach should make little practical difference in most cases. Nevertheless it does alter the burden of demonstrating the applicability of the legislation. Whereas under the provincial laws a person who trades must prove that he is entitled to an exemption, under the Draft Act the Commission must show that he is required to register. Although this approach removes the Commission's ability to deny the exemptions and thus preclude a person from trading altogether, the Commission may achieve a similar result more directly in appropriate cases under the remedial provisions of part 14.

As a result of basing the licensing requirements on a "business" rather than a "trading" standard, exemptions are required only for the relatively few types of *business* for which the protection of the Draft Act is unnecessary – for example, trading by a financial institution for its own portfolio.¹⁰

A requirement that market actors obtain a licence is probably "the most difficult element of a [federal] securities law" to justify on constitutional grounds.¹¹ However, the licensing of and establishment of standards for securities professionals are integral and necessary parts of any comprehensive securities law and should come within federal legislative authority.¹² In any event, the same ends can for the most part be accomplished through the Commis-

6 See *e.g. id.* s. 19.

7 See Ontario Securities Act, 1978, ss. 34, 71.

8 See *e.g. Connelly* at nn. 15, 36. On the exemptions generally see *id.* ch. II.A.

9 See section 8.01; and see *e.g. J. WILLIAMSON, SUPP.* at 117-18; *Connelly*, ch. VI. 2.

10 See generally subsections 8.06(2), (3); *Connelly* at nn. 74-77; and *cf. J. WILLIAMSON, SUPP.* at 118.

11 *Anisman & Hogg* at n. 203.

12 See *id.* at nn. 208-11.

sion's powers under part 9 to establish standards for membership in a registered securities exchange or other self-regulatory organization and for the conduct of such an organization's members.¹³ Part 8 of the Draft Act imposes these requirements directly in order to provide a basis for a comprehensive scheme of regulation of the Canadian securities market.

Assuming Parliament may impose a registration requirement, a number of alternative methods are available. For example, persons may be prohibited from trading in securities through a registered securities exchange without a licence; this technique would cover most brokers and dealers in Canada. Similarly the Part might be limited to securities firms that carry on an inter-provincial or national business in order to minimize the need to obtain a licence in each province in which they locate an office.¹⁴ And as salesmen tend to be employed only in one province, it would be possible to follow the U.S. model and to license firms but not salesmen and merely provide a means to prohibit dishonest salesmen from being employed by a registrant or to otherwise discipline them.¹⁵ Once again, in order to provide a complete model securities law, the Draft Act adopts the direct approach and makes both securities firms and their salesmen subject to part 8.¹⁶

However, as with distributions, there is little reason to interfere with the establishment of standards for purely local businesses. Part 8 therefore exempts firms that carry on business exclusively in one province.¹⁷ In short, part 8 applies only to brokers, dealers and advisers that carry on an interprovincial securities business, to their salesmen, and to persons who act as underwriters in connection with an interprovincial distribution.¹⁸ And coordination with the provincial laws, as well as avoidance of duplication of administrative effort, is reinforced by requiring the Commission to grant a licence to a person registered in any province at least for purposes of local trading.¹⁹

Two other variations from the provincial acts are worthy of mention. The provincial legislation gives a blanket discretion to the commissions to grant or deny registration.²⁰ Some basis for predicting the outcome of cases before the commissions may be

13 See *id.* at n. 213.

14 See e.g. *Connelly*, ch. II.D.

15 See e.g. *id.* at nn. 171-74.

16 See *id.* at nn. 175-76.

17 See section 8.07; cf. section 6.05 and Commentary.

18 See section 16.01 and Commentary.

19 See section 8.03.

20 See e.g. Ontario Securities Act, ss. 7-8 (registration where "applicant is suitable...and the proposed registration is not objectionable"; suspension where "such action is in the public interest"); Ontario Securities Act, 1978, ss. 25-26 (same).

obtained from their published decisions.²¹ The Draft Act attempts, where possible, to establish the standards for the exercise of the discretionary powers in the legislation itself. Nevertheless, as no such set of criteria can be exhaustive, a residual discretion to deny registration is retained.²²

Part 8 also empowers the Commission to establish standards of conduct for registrants by authorizing it to establish conditions of registration.²³ All such provisions must be imposed by regulation or by order, and the Commission's regulatory powers in this regard are further specified in part 11 which deals with market conduct of registrants. Detailed procedures are established in part 15 to ensure that the demands of natural justice are fulfilled in connection with both the adoption and application of such standards.

Part 8 is closely related to part 9 which requires registration and establishes standards for self-regulatory organizations. It is likely that most registrants will be members of a registered securities exchange or association of securities firms and that the self-regulatory organizations will, initially at least, supervise the trading and conduct of their members and initiate proceedings for the imposition of disciplinary measures and will, as a result, alleviate much of the Commission's regulatory burden. Moreover, although the Draft Act does not require registrants under part 8 to join a self-regulatory organization, the Commission may delegate its supervisory functions over them to a registered self-regulatory body and may thus accomplish the same result.²⁴ In short the Draft Act envisages comprehensive and integrated regulation of market actors by the Commission and by the self-regulatory organizations subject to the Commission's supervision.

Section 8.01

Section 8.01, the basic registration provision, derives primarily from the provincial source provisions in coverage although not in approach. The section requires registration only of brokers, dealers and advisers who carry on business as such.²⁵ The concept of carrying on business as the standard for registration permits some compression in the drafting of the provision. For example, because salesmen, partners and officers of a broker or dealer who trade on its behalf carry on business, they must be separately

21 See e.g. *Connelly* at nn. 481-89; J. WILLIAMSON, SUPP. at 23-26.

22 See subsection 8.02(2).

23 See subsection 8.02(3) and Commentary.

24 See section 9.05.

25 See sections 2.02, 2.07, 2.14 ("adviser", "broker" and "dealer").

registered. And there is no need to provide a specific power to designate non-trading employees of a registrant.²⁶ As such persons work in a registrant's back office or perform other clerical or administrative tasks, they are not carrying on business as brokers or dealers despite the breadth of the definition of trading. In any event the Commission may exempt any such person under section 3.03.

Because of the broad definition of "trade" in section 2.48 there will inevitably be some overlap between the various provisions of subsection (1). As an adviser may trade when he gives investment advice in furtherance of a purchase or sale, it is arguable that he would have to register under both paragraphs (a) and (b). However, a person who merely provides advice does not trade as an agent or a principal and is therefore neither a broker nor a dealer subject to the initial paragraph. (Although it is arguable that such persons should not have to register, they have been required to do so in Canada for some time and the Draft Act does not alter this pattern.²⁷) Where a person performs both advisory and broker or dealer functions it is expected that the Commission will coordinate the standards for registration, and paragraph 8.06(4)(a) indicates clearly that dual registration is unnecessary.²⁸ The key factor in the provision is whether a person carries on business as a trader. While the concept connotes something more than an isolated transaction, it does not require that a person engage exclusively or even primarily in the securities business.²⁹

The registration requirement for underwriters is broader than for others because paragraph (1)(c) applies to persons who "act as" underwriters. In most cases persons who so act will also carry on an underwriting business. However, the definition of "underwriter" also includes a person who acts in furtherance of a distribution whether or not he does so as part of a business.³⁰

Subsections (2) and (3) duplicate in substance the Canadian source provisions. The latter subsection requires notice only in respect of the new employment of a salesman because a broker or dealer and a salesman are required under section 8.04 to notify the Commission of the commencement and termination of the salesman's employment as well as of a number of other matters.

26 Cf. e.g. Ontario Securities Act, s. 6(5); Ontario Securities Act, 1978, s. 24(3).

27 But see, *Connelly*, chs. II.C., VI.4.

28 See e.g. Ontario Securities Regulations, s. 2(3); *Connelly* at n. 102.

29 See e.g. *Tara Exploration and Development Co. Ltd. v. M.N.R.*, 24 D.T.C. 6370 (Exch. 1970), *affirmed on other grounds*, [1974] S.C.R. 1057 (1972); see generally 2 L. Loss at 1295-98; 5 *id.* at 3355-57.

30 See section 2.49 and Commentary.

Section 8.02

The structure of section 8.02 is relatively straightforward. Subsection (1) requires the Commission to grant an application for registration unless the applicant comes within one of the paragraphs in subsection (2) in which case the Commission retains a discretion to grant or deny the application. As applications for renewal and reinstatement are only specific kinds of applications for registration, it is not necessary to mention all three expressly.³¹ Similarly, the section does not expressly authorize a second application on the basis of new material because such a provision would be redundant. The section follows the new Ontario act in expressly requiring Commission approval for a registrant to surrender his registration in order to ensure that investors who have dealt with him may be protected, and for the same reason the Commission is authorized to impose conditions on a registrant before allowing him to give up his status as such.³²

Subsection (2) integrates the standards for denial of an application for registration and for suspension, cancellation or other disciplinary action after it has been granted. There should be no distinction for purposes of natural justice between denial of an initial application and cancellation of a licence already granted, for both types of decision in effect deprive a person of his chosen method of earning a living.³³

Although the majority of the criteria for Commission action derive from the *ALI Code*, s. 1809(a), they reflect as well the standards developed by the provincial commissions in adjudicative proceedings dealing with registration and registrants.³⁴ Paragraphs (2)(a) to (f), therefore, merit only brief comment. There is some overlapping between paragraphs (2)(a) and (b) and paragraph (2)(d) in that a misrepresentation or omission in an application or Commission proceeding would violate the Draft Act. The two former provisions are expressly included because they reflect well established Commission standards. However there is no separate treatment of other types of misrepresentation as they are all violations of part 12.³⁵ The latter paragraph is also broader than the source provision as it includes a violation of the Draft Act and of other securities laws, as well as violations of by-laws of a regis-

31 Cf. Ontario Securities Act, s. 7; Ontario Securities Act, 1978, s. 25.

32 See subsection (7); cf. Ontario Securities Act, 1978, s. 26(3).

33 See e.g. *Connelly* at nn. 245-46; and see P. ANISMAN, A CATALOGUE OF DISCRETIONARY POWERS IN THE REVISED STATUTES OF CANADA 1970, 11 (1975).

34 See e.g. J. WILLIAMSON, SUPP. at 22-25; *Connelly* at nn. 481-89.

35 Cf. ALI FEDERAL SECURITIES CODE, s. 1809(a)(4).

tered self-regulatory organization.³⁶ The paragraph thus ensures that the Commission may deny registration not only for an offence involving fraud but also for any other type of violation of a securities law.³⁷

Paragraph (f) leaves a residual discretion to the Commission so that it may deal with cases that do not fall within the specified standards, for example, a breach of a customary ethical practice in the securities market that is not prohibited by the statute or the by-laws of a self-regulatory organization. Even this paragraph, however, establishes an express standard; consideration of a person's "suitability" for registration must relate to the protection of investors.³⁸ The standard was taken from the provincial legislation concerning applications for registration rather than the provisions concerning suspensions because it provides a more concrete test than "the public interest".

Under subsection (3) the Commission may impose conditions on registration to establish further prerequisites for obtaining a licence or to govern the conduct of registrants after a licence is granted. This technique has been used under the provincial legislation to promulgate criteria for the financial responsibility and residence of registrants.³⁹ The Draft Act authorizes the Commission to follow the same pattern or to impose conditions on a particular registration by order. Although the variety and type of conditions possible are not limited, subsection (3) specifies the two types that are likely to be most common and, in fact, are likely to be dealt with through regulations, namely, conditions relating to the financial responsibility and educational qualifications of registrants. It is expected that the Commission will not vary the current educational requirements substantially.⁴⁰ The Commission need not, however, use the power to specify conditions of registration to deal with all matters relating to the conduct of registrants because it has specific authority under part 11 to prescribe a registrant's duties to his customers and to regulate the conduct of registrants who do not belong to a self-regulatory organization.

While conditions under subsection (3) may be tailored to individual cases ("by order"), conditions concerning ownership by non-Canadians may be imposed under subsection (4) only by regulation. The Commission therefore must follow the procedure speci-

36 See e.g. *Connelly* at n. 467; *In re Roger Brian Ashton*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, April 21, 1978, at 2 (violation of North Dakota Securities Act); and see National Policy No. 17, 2 CCH CAN. SEC. L. REP. ¶54-854 (May 1978).

37 See paragraph (2)(c); and see, *Connelly*, n. 179.

38 Cf. *Connelly* at n. 483.

39 See e.g. Ontario Securities Regulations, ss. 6-6f.

40 See e.g. *Connelly*, ch. III.C.1.

fied in part 15 for making regulations if it determines to establish foreign ownership criteria as conditions of registration, as has been done under the Ontario legislation.⁴¹

There was substantial division among the advisers to the Securities Market Study over whether a provision like subsection (4) should be contained in the Draft Act or whether the question of foreign ownership of securities firms should be left to the Foreign Investment Review Agency to deal with under the Foreign Investment Review Act.⁴² Subsection (4) reflects the view that the securities industry constitutes a "key sector" of the Canadian economy for which some form of protection from potential foreign domination may be required.⁴³ Following the approach of the Canada Business Corporations Act, s. 2(1), the Draft Act leaves to the Commission the determination of the definition of "resident Canadian" and enables it to devise the detailed mechanisms, if any, that it concludes are necessary or appropriate to the protection of the Canadian securities industry.⁴⁴ By granting the Commission the discretion to deal with matters of foreign ownership the Draft Act makes clear that the Commission is the appropriate body to determine fitness for registration as a securities firm and that its jurisdiction on the question of foreign ownership is exclusive.⁴⁵

The Commission may not deny registration or discipline a registrant without providing him with an opportunity to be heard. Although section 8.02 does not itself expressly deal with a hearing, section 15.17 requires that the Commission grant a hearing before making a final order and specifies the procedures for such a hearing. As a result, the Commission must provide a hearing even where it merely imposes conditions on a registrant who wishes to surrender his registration under subsection (7). Although it is likely that most registrants will not request a hearing in such cases, the requirement is included to provide an avenue for judicial review.

However, there may be cases in which the time necessary for a hearing would subject investors to unreasonable risks from an unscrupulous or incompetent registrant. Subsection (6) therefore authorizes the Commission to suspend a registration, but not to impose any other sanction, by issuing a summary order. If it does so, it is required to hold a hearing within fifteen days and the

41 See Ontario Securities Regulations, ss. 6a-6f; and see generally, *Connelly*, ch. V.B.

42 S.C. 1973-74, c. 46.

43 Cf. generally Arnold, *Restrictions on Foreign Investment in Canadian Financial Institutions*, 20 U. TORONTO L.J. 196 (1970).

44 Cf. Ontario Business Corporations Regulations, s. 11.

45 See section 9.09, Commentary.

suspension remains in effect until the completion of the hearing. While it is necessary to allow sufficient time for the Commission to schedule a hearing without forcing it to allow an unworthy registrant to continue to inflict harm on investors, the precise time necessary to permit it to do so is not clear. The fifteen-day period in the provincial acts was retained because no cases of gross injustice to registrants appear to have resulted from the exercise of the power of summary suspension.

Subsection (5) reinforces the Commission's powers by authorizing it to require an applicant or a registrant to provide further information and to verify it by affidavit evidence or testimony under oath. The section thus enables the Commission to probe further than the required documents permit in proceedings relating to the granting or continuation of registration. While the Commission's investigative powers in part 14 would enable it to obtain the same information where it suspects that a violation of the Draft Act has been committed or that an applicant has not supplied complete information on his background, subsection (5) permits it to obtain the information without initiating a full investigation under section 14.01 and therefore provides a useful adjunct to the Commission's enforcement powers in relation to registrants.

Section 8.03

Section 8.03 parallels the provision requiring the Commission to issue a receipt for a prospectus that has been accepted by a provincial securities commission.⁴⁶ The purpose of the section is to ensure the coordination of the Draft Act and the provincial laws both in substance and in administration. Part 8, like part 5, also contains an exemption for securities firms that operate exclusively in one province.⁴⁷

The effect of section 8.02 is to compel all securities firms carrying on business in more than one province and persons employed by them, including those currently registered in a province, to obtain registration under the Draft Act. Section 8.03 in effect creates a grandfather registration for firms carrying on an interprovincial securities business and for their partners, officers and employees. The Commission may, however, limit their registration under the Draft Act to the provinces in which they are currently licensed since it is required to grant registration to them to carry on the business for which they are registered in the

46 See section 5.10 and Commentary.

47 See sections 6.05, 8.07.

provinces. Section 8.03 thus provides as well a means to permit the provincial commissions to screen salesmen of such firms who will probably make their initial application for registration in the province in which they are employed. However, once a person becomes registered, he is subject to all of the provisions of part 8.

Section 8.04

Section 8.04 follows the provincial models and requires a registrant to notify the Commission of any changes that may affect his registration. The provision compresses into subsection (1) the requirements of the source provisions applicable to a "securities firm" which is defined to include a broker, dealer, underwriter and adviser.⁴⁸ Because persons registered as advisers and underwriters do not employ salesmen and are not likely to open branch offices, they will usually have no reason to file notices under paragraphs (1)(d) to (f). But the other paragraphs apply to all firms.⁴⁹ Paragraph (1)(d) and subsection (2) complement the automatic suspension of salesmen under subsection 8.01(3) upon termination of their employment.

The information required by paragraph (1)(c) is necessary to enable the Commission to know who holds a sufficient equity interest in a registrant to exert an influence on its policies and practices. Taken literally, however, the paragraph requires reports on any change in equity ownership and would make it difficult for a securities firm to distribute its securities to the public. The new Ontario act expressly authorizes the Director of the Commission to exempt securities firms that are reporting issuers from its equivalent requirement.⁵⁰ The Draft Act leaves the matter to the Commission's general exempting power under section 3.03 under which the Commission may fashion appropriate exemptions. Should a Canadian firm go public, it is expected that the Commission will exercise its exempting power so that reporting is required only for changes in equity ownership that are likely to alter the control structure of the firm.⁵¹

Section 8.05

Section 8.05 requires a registrant to maintain records of his business and affairs sufficient to enable an auditor to report to the

48 See section 2.43.

49 See section 2.43; *cf.* Ontario Securities Act, 1978, ss. 32(1) (dealers) and (2) (advisers and underwriters).

50 See Ontario Securities Act, 1978, s. 32(4).

51 See generally, Connelly, ch. V.A.

Commission on them or to enable the Commission itself to investigate allegedly improper conduct.⁵² Like the source provisions, subsection (1) also imposes a duty on registrants to file an annual financial statement and other periodic reports prescribed by the Commission. However, following the approach adopted throughout the Draft Act, the form and contents of the financial statements required to be filed are left to be determined by the Commission by regulation.

The Canadian source provisions apply only to registrants who are not members of a self-regulatory organization.⁵³ Subsection 8.05(1) extends the requirement to all registrants so that the Commission may establish directly, rather than through the self-regulatory bodies, minimum reporting requirements for all registrants. Nevertheless, the auditing of most registrants will continue to be performed, as at present, by an auditor who is selected from a panel established by the self-regulatory organizations and who will report to the organization rather than the Commission.⁵⁴ Subsection (2) therefore applies only to nonmember securities firms and adapts to them an express audit requirement similar to that applicable to members of self-regulatory bodies. Again the subsection authorizes the Commission to prescribe the nature of the audit and imposes a duty on the auditor to report to it. The Commission may, however, delegate the audit functions of nonmembers to a registered self-regulatory organization under section 9.05.

Subsection 8.05(1), like the source provisions, applies to all classes of registrant and thus empowers the Commission to prescribe the reports that must be filed by registered advisers and underwriters and even by salesmen. The records that must be maintained will, of course, be determined largely by the type of reports required. And the Commission's regulation-making powers will enable it to tailor the types of reports to the nature of the business conducted by a registrant. The Commission may, therefore, require detailed reports to be filed by brokers, dealers and underwriters, less detailed ones by advisers, and presumably will require minimal, if any, reporting by salesmen.

As the required reports must be filed with the Commission, they will be available for public examination unless the Commission orders otherwise.⁵⁵ Although they are not so filed under the provincial legislation, it is reasonable that they be available for inspection so that investors may determine the financial stability

52 See section 2.34 ("records").

53 See *e.g.* Ontario Securities Act, 1978, s. 21.

54 See section 9.11; *cf. e.g.* Ontario Securities Act, 1978, ss. 19-20.

55 See sections 2.20 ("filing"), 16.08.

of the securities firms with which they deal.⁵⁶ In fact, as a number of the larger Canadian firms now file annual financial statements under the Canada Business Corporations Act, s. 154, the general requirement in section 8.05 is likely to prove beneficial by treating all registrants in the same manner.

The filing of regular financial reports by registrants provides only one method of surveillance. It is supplemented by the Commission's ability to make "spot audits", that is, to appoint a person to examine a registrant's records at any time without warning.⁵⁷ However, as spot audits are primarily a method of enforcement, the Commission's power to conduct them is included in section 14.03.

Section 8.06

Because the provincial securities acts prohibit all trading by persons who are neither registered nor exempt from registration, a large number of transactions and securities are exempted in order to limit the effect of the prohibition to persons who conduct a securities business.⁵⁸ The approach to registration in this Part obviates the need for many of these exemptions. The exemption for isolated trades, for example, is no longer required as such a transaction does not constitute carrying on business.⁵⁹ Similarly the substantial number of exemptions in the provincial acts for trades by an issuer, such as rights offerings, stock dividends, exchange offers, purchases of assets and sales to employees, are not required.⁶⁰ And the exemption for transactions between underwriters is superfluous as underwriters must register in any event under paragraph 8.01(1)(c).

The focus on business rather than trading also affects the exemptions for specified types of securities. The provincial acts exempt persons who trade in government and municipal bonds and securities of nonprofit organizations, cooperatives, credit unions, banks and insurance and trust corporations.⁶¹ Trading by securities professionals in all of these types of securities is subject

56 Cf. ALI FEDERAL SECURITIES CODE, s. 1805(d).

57 See e.g. Ontario Securities Act, 1978, s. 18.

58 See e.g. Ontario Securities Act, s. 19; Ontario Securities Act, 1978, s. 34. The exemptions in the provincial laws are discussed in J. WILLIAMSON, SUPP. at 126-55; and a list of the exemptions from registration in all the provincial acts as of 1966 is included *id.* app. D., at 454-99; see also D. JOHNSTON at 117-28.

59 See e.g. Ontario Securities Act, s. 19(1)2; Ontario Securities Act, 1978, s. 34(1)2; and see section 8.01, Commentary.

60 See e.g. Ontario Securities Act, ss. 19(1)8, 9, 9b, 10; Ontario Securities Act, 1978, ss. 34(1)12, 14, 16, 18, 19; and see section 8.01, Commentary.

61 See e.g. Ontario Securities Act, ss. 19(2)1, 6, 7, 8; Ontario Securities Act, 1978, ss. 34(2)1, 7, 8, 9.

to potential abuse, particularly in relation to securities held for customers and investment advice. The honesty, competence and financial stability of persons who deal in securities exempt from the prospectus requirement is as necessary as when they deal in non-exempt securities. This need was made manifest by the U.S. experience with trading in municipal bonds which led to the amendments to the Securities Exchange Act of 1934 requiring municipal bond dealers to register.⁶²

The only "persons" exempted from registration because of their nature are Canadian governmental bodies, that is, the federal and provincial governments and municipalities and Canadian public authorities.⁶³ Such "persons" are exempt because their advice will relate primarily to government securities that are secure and because they do not hold securities for clients. And the exemption for their employees follows. Nevertheless, government employees who give negligent advice concerning the securities of their employer may in some circumstances incur liability to an investor who suffers damage by following it.⁶⁴

The remaining provisions of the section are directed at the types of business that do not require registration. Thus subsection (2) exempts persons who carry on a securities business only where the business is *exclusively* in securities which are customarily dealt with in a well understood commercial context in which professionals either do not deal or are otherwise regulated.⁶⁵ The exemption is repeated, despite the applicability of section 3.01 to the whole of the Draft Act, to avoid an interpretation that might require registration of persons who deal in the specified securities. All of the other parts of the Draft Act apply to securities rather than to persons who carry on business. Although it is arguable that securities specified in section 3.01 are also excluded from the definitions of the various classes of registrants and, therefore, that persons who trade in such securities are not subject to part 8, paragraph (2)(a) is intended to put the matter beyond doubt. However, securities of "private issuers" which are exempted under paragraph 3.01(e) are not included in paragraph (2)(a). Even though it is highly unlikely that a market in such securities would ever develop, a person who deals in them with the public should not be

62 See e.g. *Williamson, Capital Markets*, ch. II.H.2; and see ALI FEDERAL SECURITIES CODE, s. 703(a)(2).

63 See subsection (1).

64 See e.g. *Haig v. Bamford*, 72 D.L.R. (3d) 68 (S.C.C. 1976); *Gadutsis v. Milne*, [1973] 2 O.R. 503 (H.C.); but see *Mutual Life and Citizen's Assurance Co. Ltd. v. Evatt*, [1971] A.C. 793 (P.C.).

65 See paragraph (2)(a) and section 3.01, Commentary; cf. ALI FEDERAL SECURITIES CODE, s. 702(b)(1) ("to the extent that he does business" in an exempted security).

exempt from registration (provided, of course, that his business is interprovincial).⁶⁶

In addition to the securities discussed above, the subsection exempts securities of mutual funds. As mutual funds are dealt with in the *Mutual Fund Proposals*, they are excluded from the Draft Act on the assumption that the two sets of proposals will be treated together should Parliament decide to act.⁶⁷

Paragraph (2)(c) exempts persons who deal exclusively with institutional investors. But dealing with "sophisticated investors" within subsection 6.02(2) is not exempt as they may be members of the public who require the advice and services of securities professionals. Institutional investors are presumably in a position to obtain sound advice and to protect themselves even from a broker or underwriter making a private placement. Although these conclusions may be subject to reasonable doubt, there has been little indication that institutional investors have suffered harm from the fact that persons who negotiate private placements are not required to register under the provincial acts. The Draft Act therefore continues this policy.

Paragraph (2)(d) exempts lenders who take securities as collateral for a loan made to a control person of an issuer. There is no need to require such persons to register as underwriters when they sell the securities to liquidate the debt, because they do not carry on a securities business with the public and because, in any event, the sale is subject to part 5 unless a separate exemption is granted by the Commission.

Subsection (3) provides exemptions for persons who as part of their ordinary business activities trade in securities as principal or agent, that is, act as brokers or dealers, but whose primary business is not securities trading. Thus paragraph (3)(a) exempts persons who undertake the administration of another's estate or business and who may have to trade securities as a result of their responsibilities. Paragraph (3)(b) similarly exempts agency activities performed by a bank or trust company to accommodate a customer, at the customer's request, in respect of a security that is traded through a registrant.⁶⁸ And paragraph (3)(c) permits financial institutions to continue to trade securities for accounts managed by them, whether or not held in trust, and for their own portfolios. The latter exemption is necessary as such trading is part of the ordinary business of these institutions. However, as they do not deal with public investors, there is no need for them to

66 See section 8.07.

67 See subparagraph 3.02(1)(c)(iv) and Commentary.

68 See also Ontario Securities Act, 1978, s. 34(1)11.

have to register merely because of such trading. The exemption impliedly permits the development of a fourth market in Canada.

Paragraph (3)(d) is included to ensure that a person who regularly trades for his own account need not register. Although such a person may be said to carry on a business of trading in securities, especially if he earns his livelihood from trading, there is no need to require him to obtain a licence. As most such investors will deal through registrants, the condition that they do so in order to retain the exemption will not create any inconvenience and will ensure that they may have professional advice should they wish it⁶⁹ and that the exemption cannot be used as a means of avoiding registration as a dealer.

Subsection (4) exempts persons who provide investment advice as an incidental part of their normal business. The section derives primarily from the provincial acts and is necessary only where a person is carrying on business as an adviser.⁷⁰ The phraseology of the source provisions is retained in paragraph (4)(a), which exempts registered brokers and dealers from a duplicate registration requirement as advisers, to make clear that a second registration is not required of dealers even if they give advice for which they are separately compensated.⁷¹

The final exemption in the subsection enables newspapers and periodicals to include financial commentary without either the publisher or the author of a column having to register. The exemption is available only to publications of general and paid circulation in order to preclude its use by publishers of advisory letters that are sold only to a list of subscribers. The requirement that a periodical have a general circulation ensures that the exemption cannot be used for publications whose primary purpose is the giving of investment advice.⁷² The condition that a publication be distributed only to purchasers reinforces this approach and also precludes free distribution paid for by persons other than those who receive the publication, thus preventing potential abuse of the exemption by an indirect form of touting. Subparagraph (c)(iii) is directed to the same end. In short, if a person is to be paid for giving advice in relation to a particular security, he must be registered and subject to the Commission's supervisory jurisdiction.⁷³ The Draft Act omits the express reference to "subscrib-

69 See section 11.01.

70 See e.g. Ontario Securities Act, s. 18; Ontario Securities Act, 1978, s. 33; and see J. WILLIAMSON, SUPP. at 125-26; D. JOHNSTON at 119-22; cf. ALI FEDERAL SECURITIES CODE, s. 279(b)(2).

71 See generally, *Connelly* at nn. 113-20 and following.

72 See also subparagraph (4)(c)(iii).

73 Cf. section 12.05.

ers...for value" in the provincial statutes as such subscribers are purchasers.⁷⁴

The two conditions in subparagraphs (c)(i) and (ii) are directed to essentially the same ends. The advisory functions of a person claiming the exemption would likely not be solely incidental to the publication of a general periodical or newspaper if he otherwise carries on business as an adviser. Subparagraph (c)(i) ensures that there can be no confusion over this question. The second subparagraph is more substantive in that it is directed at potential conflicts of interest. Since one of the purposes of the requirement that advisers register is to enable the Commission to supervise their activities and so preclude such conflicts, an exemption available to persons in a position of conflict would substantially undercut the statute's thrust. Paragraph (c)(ii) therefore ensures that those with an interest in the security on which they advise must register. By dealing with all conflicts, the provision averts the grosser types of conduct, such as scalping, that are possible in such circumstances.⁷⁵

A number of difficulties with the scope of the exemption may arise. For example, some misgivings have been expressed about the meaning of "publisher" and the implications of such persons being subject to the conditions in paragraph (4)(c).⁷⁶ Such matters, however, are too refined to be dealt with by statute and are left to the Commission's general powers of exemption.⁷⁷ Similarly, the Commission may deny any of the exemptions in section 8.06 subject to appropriate conditions.⁷⁸

Section 8.07

Section 8.07 indicates the transprovincial impetus of the Draft Act by exempting persons who carry on business exclusively in a single province. The section makes clear that only those who do business in more than one province, that is, who conduct an interprovincial business, must register. It thus reinforces both the constitutional underpinning of the Draft Act and the policy in favour of leaving to the provinces the determination of legislative solutions and standards appropriate for conduct that affects only local residents. The section therefore is not only parallel to section

74 Cf. *e.g.* Ontario Securities Act, 1978, s. 33(d).

75 Cf. *SEC v. Campbell*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶93,580 (SEC complaint); *Zweig v. Hearst Corp.*, 407 F. Supp. 763 (D.C. Cal. 1976); and *cf. Anisman* at 216-17; see also section 11.02 (registrants' conflicts of interest).

76 See *e.g.* *D. JOHNSTON* at 121-22.

77 See section 3.03.

78 See section 3.04.

6.05 but is also coextensive with section 16.01.⁷⁹ In fact, it is arguable that the latter provision makes section 8.07 superfluous because interprovincial trading is a necessary element of carrying on an interprovincial business. Nevertheless, it is included to avoid any ambiguity that might result from the business criterion adopted in this Part.

Even one interprovincial transaction may be enough for a person to lose the exemption in section 8.07 (“only in one province”). Any further exemptions based on “isolated transactions” must be determined by the Commission which will be able to define specific limitations more precisely in the light of its experience and to adapt them to particular cases.⁸⁰

79 See sections 6.05, 16.01, Commentary.

80 See section 3.03; *cf.* section 8.01, Commentary.

Part 9

Self-Regulatory Organizations

Self-regulation has long had a prominent role in the supervision of the securities markets. When the Securities Exchange Act of 1934 was enacted to regulate trading on the securities exchanges of the United States, it was not surprising that Congress attempted to harness the already existing exchange organizations to supervise their members and trading on their floors in furtherance of the statutory goals. The exchanges had the expertise necessary to police conduct in the market, the ability to impose reasonable ethical standards and the flexibility to apply them reasonably, all of which presumably enabled them to ensure compliance with both their by-laws and the legislative scheme. Moreover, involvement of the exchanges in the regulation of the market appeared likely to be less costly and to encourage a readier acceptance of the legislation by the members of the securities industry.¹ The approach appeared sufficiently successful that it was extended to the over-the-counter market, subject to more direct supervision by the Securities and Exchange Commission, by the Maloney Act in 1938.²

However, a number of potential difficulties inhere in any scheme that permits an industry to regulate itself. Aside from the dangers of lax and overzealous enforcement, a self-regulatory body that controls entry into its ranks and therefore into the

1 See e.g. *Dey & Makuch*, ch. V; cf. D. JOHNSTON at 386.

2 See e.g. 2 L. Loss at 1359-91.

market it regulates always has a conflict of interest in that restrictive policies on such matters will enhance the position of its members. In other words, self-regulation necessarily involves a potential for anticompetitive conduct by the self-regulators who may attempt to further their own market position. These limitations in the self-regulatory structure of the U.S. securities industry were highlighted by a number of developments in the 1960s, namely, the increasing institutional involvement in the market, the increase in the volume of securities trading that resulted in the collapse of a number of large securities firms, the application of the antitrust laws to securities activities, and advances in computer technology that permit integration of the securities market, all of which in combination led to the enactment of the Securities Reform Act of 1975. The new act became law shortly after the Securities and Exchange Commission had eliminated fixed commission rates on the exchanges and reflected experience with self-regulation in the securities market during the preceding forty years.

The act did not, however, discard the principle of self-regulation. Rather it indicated acceptance of its benefits and attempted to control its potential limitations by imposing on the Securities and Exchange Commission responsibility to supervise the self-regulatory bodies more closely and especially to review their practices and by-laws to ensure that they do not impose constraints on competition that are not necessary for the protection of investors and the efficient operation of the securities market. The Commission was also required to foster the development of a national securities market by exploiting as far as possible existing market institutions and new computer-communications technology.³

An even broader acceptance of the principles of self-regulation is reflected in the United Kingdom where the long-standing debate over the comparative benefits of self-regulation or government regulation of the securities market appears to have been decided in favour of the former. The apparent success of the Panel on Take-overs and Mergers, a self-regulatory body that operates much like a North American administrative agency but without statutory investigative or penal powers, seems to have provided a model for the development in 1978, under the auspices of the Bank of England, of the Securities Industry Council to supervise conduct of all aspects of the securities market in the United Kingdom. The stock exchanges are, of course, represented on the Council and the Panel on Take-overs and Mergers has been absorbed into it.⁴

3 See Securities Exchange Act of 1934, s. 11A.

4 See generally, *Dey & Makuch* at n. 159; and see PANEL ON TAKE-OVERS AND MERGERS, REPORT ON THE YEAR ENDED 31ST MARCH 1978, 3-7 (1978).

The experience in Canada is closer to that in the United States. The early Canadian securities laws assumed the continued existence of the stock exchanges and in the 1930s delegated to them the primary responsibility for performing audits on their members.⁵ And the self-regulatory principle was extended in the following decade to other bodies whose members traded in the over-the-counter market.⁶ However, the only sanction available to the securities commissions, denial of recognition and therefore of the right to carry on business, was too draconian and consequently the practice of self-regulation in Canada succumbed on occasion to the weaknesses inherent in it. Following the publication in 1965 of a study by a royal commission and of a report of a committee of the Ontario Attorney-General, the legislative scheme in Ontario was substantially reformed.⁷ The Ontario Securities Act, 1966, gave to the Ontario Securities Commission plenary jurisdiction over the Toronto Stock Exchange and in 1968 was amended to extend the Commission's jurisdiction to include review of the exchange's disciplinary and listing decisions.⁸ Similar provisions have since been enacted in all of the other provinces in which a stock exchange is located.

During the last decade the provincial commissions have been catapulted into direct regulation of the Canadian securities exchanges, partly because of their new supervisory powers but more so because of developments in the market itself, often influenced by those in the United States and on occasion by other legislation affecting the self-regulators. For example, the Ontario Securities Commission first considered the fixed commission rate structure of the Toronto Stock Exchange, and therefore the rate structures of the other Canadian exchanges, in a 1967 decision that perfunctorily approved the exchange's by-law.⁹ Since then, however, undoubtedly influenced by the intense challenge to fixed rates on the New York Stock Exchange that culminated in their abolition by the SEC as of May 1, 1975, the OSC's scrutiny of applications by the exchange to alter its rate structure has become increasingly severe.¹⁰ And detailed analysis of such issues has

5 See e.g. *Dey & Makuch*, ch. IV.B. On the history of self-regulation in Canada generally, see *id.* ch. IV; J. WILLIAMSON, SUPP., ch. X; Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. AD. 325 (1965).

6 See e.g. *Dey & Makuch*, chs. IV. E-F; J. WILLIAMSON, SUPP. at 293-98.

7 See e.g. KIMBER REPORT, pt. VII; WINDFALL REPORT; and see, *Dey & Makuch*, ch. IV. G-J.

8 See S.O. 1966, c. 142, s. 139, amended, S.O. 1968-69, c. 116, s. 9; and see now Ontario Securities Act, s. 140.

9 See, *In re the Toronto Stock Exchange*, [1967] OSC Bull. 15 (June).

10 See e.g. *Dey & Makuch* at nn. 200-04; *Williamson, Financial Institutions*, chs. III.B, E.

been undertaken by the Quebec Securities Commission as well.¹¹ Similarly, the proposed amendments to the Combines Investigation Act which would exempt regulated industries from the act's coverage only for conduct expressly required by a public authority may have influenced the Ontario commission to consider proposals of the Toronto exchange more carefully.¹²

The tendency of the commissions to exercise their recently conferred supervisory powers over the exchanges has been accelerated not only by the movements in the U.S. market and by competition policy but also by the increasing use of computer technology in the Canadian market itself. The development of the Canadian Depository for Securities and of the Vancouver Stock Exchange's clearing system and particularly of the Toronto Stock Exchange's computer-assisted trading system (CATS) indicates that the Canadian securities market too is moving toward a national trading and clearing system under the auspices of the self-regulatory bodies.¹³ As supervision by a government agency will obviously be necessary, the provincial commissions must be prepared to deal with such developments.¹⁴

Whatever the reasons, the provincial commissions have now developed procedures for dealing with the conduct of the self-regulatory organizations, whether it be a change of by-laws or a decision directed at an individual member or listed issuer, which are substantially similar to those mandated under the Securities Reform Act of 1975 and included in the ALI codification.¹⁵

Part 9 of the Draft Act formalizes the present practices of the Canadian securities commissions. It requires self-regulatory organizations, defined exclusively in terms of their public functions, to become registered under the Part and it establishes standards for registration and conduct of such bodies subject to the supervision of the Commission.¹⁶ As with the registration of securities firms, part 9 contains a grandfather clause requiring the Commission to register a self-regulatory organization that is now recognized by a provincial commission.¹⁷ Once registered, a self-regulatory organization must obtain the Commission's approval for all substantial

11 See e.g. *id.* ch. III.C.

12 See e.g. Notice: Proposed Revision of the By-Laws of the Toronto Stock Exchange concerning Trading in Rights, OSC Weekly Summary, March 10, 1978, at 1A; and see e.g. Dey & Makuch, ch. XI.

13 See e.g. Cleland; cf. Jenkins.

14 But see, Anisman & Hogg, ch. III.C.

15 See e.g. ALI FEDERAL SECURITIES CODE, pt. VIII; see also e.g. Dey & Makuch, at nn. 177-78; Connelly, ch. IV.A.

16 See sections 9.02, 9.06; see also sections 2.05, 2.10, 2.42 and Commentary ("association of securities firms", "clearing agency" and "securities exchange", respectively).

17 See section 9.04; cf. section 8.03 and Commentary.

alterations of its constitution including any amendments to its by-laws. And the Commission, in considering such amendments, is required to evaluate not only their conformity with the purposes of the Draft Act but also their effects on competition policy in relation to the other policies of the Draft Act.¹⁸

Part 9 also ensures fair treatment of members of a self-regulatory organization, both with respect to their ability to become members, that is, their entry into the market, and with respect to disciplinary proceedings after they have done so, by establishing mandatory procedures for such functions and by requiring each organization to include the procedures in its constitution.¹⁹ A right of appeal to or review by the Commission provides a further constraint to ensure the fairness of decisions and the decision-making process.²⁰ And the Commission's decision itself is reviewable by a court under section 15.19.

Finally, part 9 recognizes the existence of the contingency fund that has been established by the Canadian self-regulatory bodies to protect investors from the bankruptcy of their members. Section 9.13 requires the continuation of the contingency fund and, like other self-regulatory functions, subjects it to Commission oversight.

In brief, the Part, while recognizing and adopting the present Canadian scheme of self-regulation, formalizes the procedures, particularizes the standards for its continued functioning, and subjects the overall scheme to Commission supervision. In doing so, it expressly imposes on the Commission the duty of reconciling any conflict between competition policy and the needs of an efficient securities market and the protection of investors and of ensuring fair implementation by the self-regulatory organizations of their functions.

Section 9.01

Section 9.01 requires registration of a self-regulatory organization that carries on its activities in Canada. The section relies on the definitions of "securities exchange", "clearing agency" and "association of securities firms", each of which is defined in terms of the public functions it performs.²¹ Registration provides the jurisdictional nexus for the Commission's exercise of its supervisory powers over a self-regulatory organization under this Part.

18 *See generally* section 1.02 and Commentary.

19 *See* subsections 9.03(1), 9.09(4).

20 *See* section 15.18.

21 *See* sections 2.05, 2.10, 2.42 and Commentary; and *see, Dey & Makuch*, ch. VII.C; *cf.* section 8.01, Commentary.

However, should a self-regulatory organization fail to register when required to do so, the Commission may resort to its enforcement powers under part 14.

As the functions of securities exchanges and clearing agencies carrying on business in Canada are transprovincial, subsection (1) applies to all such organizations.²² Even if a clearing agency were located in a single province, its functions would be sufficiently closely related to those of an exchange that they could readily be treated as ancillary to the regulation of the exchange's activities.²³ And in any event both clearing agencies now operating in Canada conduct their business in more than one province by means of communications networks.²⁴ Although subsection (1) is drafted in a manner that makes it applicable to any number of such organizations, the direction of market developments appears to be toward a single computerized trading and clearing system.²⁵ Indeed, it is likely that such a system will develop more quickly in Canada than in the United States, despite the congressional mandate, because there are fewer institutional interests and rigidities and because the smaller number of distributions and lesser trading volume make a Canada-wide system necessary to ensure the continued functioning of an autonomous Canadian securities market as an alternative to an increasingly efficient U.S. market to which Canadian issuers and traders might otherwise turn.

Subsection (2) is expressly limited to associations of securities firms that operate in more than one province in order to make clear that it applies only to associations that have more than intraprovincial significance.²⁶ As the only association carrying on its activities in more than one province is the Investment Dealers Association of Canada, the effect of the subsection is to require it to register.²⁷ Intraprovincial organizations such as the Broker-Dealers' Association of Ontario may apply for registration under subsection (3) should they so desire.²⁸

Section 9.02

Section 9.02 establishes the registration process for self-regulatory organizations and the standard to be applied by the Commission in determining whether to grant an application for regis-

22 See e.g. *Dey & Makuch*, ch. XII.A; *Anisman & Hogg* at nn. 9-11 and ch. III.C.

23 Cf. *id.* at n. 223 and following.

24 See *id.*; and see generally, *Cleland*, chs. IV.D.5, V.

25 See e.g. *Cleland*, chs. V-VII; cf. *Jenkins*, ch. III.

26 See, *Anisman & Hogg* at n. 195.

27 See, *Dey & Makuch*, chs. II.B, VII.C, IX.D.

28 See e.g. *Dey & Makuch*, ch. II.C; cf. Canadian and British Insurance Companies Act, R.S.C. 1970, c. I-15, pt. IX.

tration. The Draft Act ensures that the procedures relating to the registration of a self-regulatory body are to be open so that any interested person may present his views to the Commission. This approach is made clear in subsection (1), which requires the Commission to publish a notice of an application for registration inviting written comments on the application. And it is reinforced by the requirement that a hearing be held even where the Commission is prepared to grant registration.²⁹ Interested persons are entitled to submit only written comments so that the Commission is not compelled to hold a multi-party hearing on each application for registration under this Part. It may, however, permit such persons to appear at a hearing if it believes that oral submissions by them would be helpful. The special treatment of self-regulatory organizations reflects the importance of their regulatory role under the Draft Act.

The scheme for registration under section 9.02 parallels that for other market actors. The Commission is required to grant registration unless a reason for denial exists (subsection (2)), and the specified standards for denial incorporate those in the earlier section.³⁰ The Commission thus has a discretion to deny an application for registration as a self-regulatory organization where the applicant has engaged in conduct indicating a lack of integrity or of competence, both of which are at least as important to registration under this Part as under part 8. Section 9.02, however, goes further than section 8.02 by requiring the Commission to deny registration to an applicant that cannot fulfill the duties of a self-regulatory organization under the Draft Act. These duties would include the enforcement of provisions of the act delegated to such an organization by the Commission pursuant to section 9.05. Equally important, subsection (3) requires the Commission to refuse to register an organization whose by-laws do not meet the standards specified in section 9.03. But where the reason for an applicant's failure to fulfill the standards for registration is a deficiency in its by-laws, the Commission may under subsection (5) require a change in the by-laws sufficient to make them conform to the requirements in section 9.03. The subsection thus enables the Commission to grant registration to a worthy applicant, despite a minor failing in its by-laws, and is in this regard analogous to the provisions of section 8.02 authorizing the Commission to impose conditions on a registration. Moreover, because a hearing is always required for the granting of registration, the changes

29 See subsection (2) ("by order"); compare section 8.02 (hearing not required unless Commission considering denial of registration).

30 See subsection (4); and see subsection 8.02(2) and Commentary.

required by the Commission will have a full airing and the need for duplicate proceedings under section 9.07 after registration is granted may be avoided.³¹

Subsection (6) requires that the Commission carefully consider the by-laws of an applicant in light of competition policy. As the most significant potential danger of self-regulation is the tendency of the self-regulatory bodies to act in their own rather than the public interest by imposing restraints on competition, it is essential that the Commission scrutinize the by-laws of each applicant to ensure that no anticompetitive provisions are included in them that are not necessary to effectuate the Draft Act's purposes.³² The subsection ensures that the Commission does so by requiring it to deal expressly with any such by-laws in the reasons that accompany its order granting registration.³³ The Commission's scrutiny and express consideration of questions concerning competition arising out of the by-laws would have the incidental effect of bringing them, and conduct under them, within the exemption for "regulated conduct" under the proposed amendments to the Combines Investigation Act.³⁴ Given the emphasis on competitive markets in part 9, it is expected that the Commission will exercise its powers under the Part to achieve the objectives of the Draft Act in the manner "least restrictive of competition".³⁵

Although the source provision specifies the materials to be submitted with an application for registration, subsection (1) follows the approach elsewhere in the Draft Act and authorizes the Commission to prescribe the form and contents of an application. It is expected that the Commission will require a copy of the constitution and by-laws of any applicant to accompany an application so that it may fulfill its duties under this section.³⁶ Similarly, the Commission may specify the materials to be submitted and the conditions for permitting a registered organization to surrender its registration. As under subsection 8.02(7), the Commission's discretion is intended to be exercised primarily to ensure the protection of investors and, in this case, also to ensure the efficiency of the securities market.³⁷

31 Cf. subsection 9.04(2).

32 Cf. subsection 9.03(4).

33 See subsection (6); and see subsection 15.17(8).

34 See An Act to Amend the Combines Investigation Act, Bill C-13, 30th Parl., 3d Sess., ss. 4.5, 4.6 (First reading November 18, 1977).

35 *Id.* s. 4.6(1).

36 Cf. ALI FEDERAL SECURITIES CODE, s. 803(a).

37 See generally section 1.02.

Section 9.03

Section 9.03, by specifying the purposes and contents of an applicant's by-laws, establishes the purposes that the self-regulatory organizations are intended to achieve under the Draft Act and sets them out as standards that an organization must meet as a prerequisite to registration. The section thus expressly establishes the statutory policy applicable to self-regulatory organizations and emphasizes the overriding purpose of the Draft Act, that is, the enhancement of efficient markets which operate fairly and without unnecessary constraints on competition. The latter goal is made clear by subsection (4) which prohibits by-laws that would have an anticompetitive or unfair impact.

The first three subsections specify the purposes which the by-laws must be designed to fulfill and other matters for which they must provide. Subsection (1) applies to all applicants, subsection (2) to securities exchanges and associations of securities firms and subsection (3) to clearing agencies. The required contents of the by-laws are relatively straightforward in light of the policy of the Draft Act but a few merit comment. Subsection (1) specifies the regulatory goals that a registrant must undertake to achieve. A registrant's by-laws must include provisions for disciplining wayward members and must reproduce the statutory procedure relating to such proceedings and to applications for membership that a registered organization is required to follow by subsection 9.09(4) (paragraphs (1)(e) and (f)). The procedure is essentially that required for Commission orders under section 15.17 and must be set out in the by-laws so that members and prospective members of a self-regulatory registrant may discover their rights simply by reading the organization's constitutional documents.

Subsections (2) and (3) specify the necessary elements of by-laws peculiar to the various types of registrants. Thus the goals expressed in paragraph (2)(a) are not required of a clearing agency and, similarly, those in paragraph (3)(a) are peculiar to one. Paragraphs (2)(b) and (3)(b), however, are directed at the same end. Both provisions, by limiting the power of a self-regulatory organization to deny membership to the grounds specified in section 9.09, ensure that an organization cannot apply standards unrelated to its functions under the Draft Act to exclude persons from entry into the securities business or market. Paragraph (2)(b), however, deals only with members and their employees whereas paragraph (3)(b) is directed at participants, that is, the financial institutions and other securities market actors who are

entitled under the Draft Act to use the facilities of a registered clearing agency.³⁸

Once an organization is registered the provisions of the Draft Act itself require that it comply with the specified standards and procedures. If a registrant fails to observe them the Commission has plenary jurisdiction to review the organization's by-laws and decisions, either on appeal by a person affected or on its own motion, and, if appropriate, to discipline the organization. And the Commission's decision is subject to further review by a court.³⁹

Section 9.04

Section 9.04 confers "grandfather" status on existing self-regulatory organizations that are registered or recognized under a provincial securities act. The dual standard is used to reflect the different terminology under the provincial laws.⁴⁰ As with other types of registrants, the right to registration under this section is limited to the capacity in which an organization is currently recognized. For example, while subsection (1) clearly includes each stock exchange that carries on business in Canada, it does not include a foreign exchange that is "recognized" under a provincial act for the purposes of the "blue chip" exemption from the prospectus requirements but that is not "recognized" for self-regulatory purposes.⁴¹ Similarly, the Investment Dealers Association of Canada and the Broker-Dealers' Association of Ontario are arguably not entitled to registration as of right under the section as their "recognition" under the provincial acts is limited to the auditing of their members.⁴² As a result only their by-laws relating to audits have been officially considered and approved by the provincial commissions.⁴³

Two other matters in subsection (1) are significant. Because the role of the self-regulatory organizations is central to the supervision of the secondary market, the Draft Act entitles such bodies to registration as of right during the first ninety days after it comes into force. The Commission may not after that period accept recognition by a provincial body as a basis for automatic registration.⁴⁴

As a corollary to registration as of right, subsection (1) does not require the Commission to invite comment or to hold a hearing

38 See sections 2.10, 2.28 and Commentary ("clearing agency" and "participant").

39 See sections 9.14, 15.18, 15.19.

40 See e.g. Ontario Securities Act, s. 140(1) ("recognized").

41 See e.g. Prince Edward Island Securities Regulations, s. 9(c).

42 See e.g. Ontario Securities Act, s. 30.

43 See e.g. *id.* s. 31(2).

44 Cf. section 8.03 and Commentary.

before granting an application. Nevertheless the Commission must scrutinize the by-laws and expressly deal with any that do not meet the criteria specified in subsection 9.02(6).⁴⁵ And if as a result of its scrutiny it decides to require any change in the by-laws of an applicant, it must hold a hearing under subsection (2). Such a hearing serves the same function as its counterpart in section 9.02, namely, to obviate a hearing at a later date under section 9.07.⁴⁶

Section 9.05

Section 9.05 highlights the unique, hybrid character of the system employed to regulate the North American securities markets. Most regulatory schemes grant exclusive powers to establish and enforce standards either to a government body or to a so-called "self-regulated profession".⁴⁷ The regulatory scheme under the securities laws falls between the two common models in that it involves the exercise of delegated governmental authority by a public authority and by one or more self-regulatory organizations subject to the authority's supervision. Indeed, one of the main characteristics of the regulation of securities markets is the tension created by the sometimes conflicting objectives of the public body and a self-regulatory organization, the former attempting to maximize competition to further the efficiency of the market's operation and to ensure the delivery of services to customers at reasonable cost and the latter being more concerned with the stability of the industry and the ethical practices of its members. The recent legislative developments in both the United States and Canada have been directed at increasing the authority and duties of the governmental supervisors.⁴⁸

Section 9.05 authorizes the Commission to delegate any of its regulatory functions under the Draft Act to a self-regulatory organization that can perform it more efficiently and so lighten the Commission's administrative burden and the direct costs to the taxpayer. The Commission may do so, for example, by requiring a registered association of securities firms to perform audits of nonmember registered firms as well as of its own members.⁴⁹ The

45 See subsection 9.02(6) and Commentary.

46 See subsection 9.02(5) and Commentary.

47 See e.g. H. JÄNISCH, *THE REGULATORY PROCESS OF THE CANADIAN TRANSPORT COMMISSION* (study prepared for the Law Reform Commission of Canada 1978); *Law Society Act*, R.S.O. 1970, c. 238, as amended (self-regulatory professional body); but see *Professional Code*, S.Q. 1973, c. 43 (subjecting professional bodies to government oversight).

48 See e.g. *Dey & Makuch*.

49 See section 8.05, Commentary; and see section 9.11.

only qualification on the Commission's powers under the section is that the delegation be consistent with the objectives, and therefore with the regulatory activities, of the self-regulatory body. And the organization that is the subject of such an order or regulation may appear and be heard before the delegation is made and may subsequently appeal the Commission's decision.⁵⁰

Subsection (2) is similarly directed at the avoidance of administrative inefficiency resulting from unnecessary duplication of effort. It authorizes the Commission to allocate functions among various registrants and to require registered organizations to act jointly in order to avoid such duplication.⁵¹ The need for the latter type of power is demonstrated by a recent decision of the Ontario Securities Commission requiring the Toronto and Montreal Stock Exchanges to cooperate in the development of a single clearing facility for options traded on the two exchanges.⁵² The Commission may also under section 9.07 require a change in an organization's by-laws in order to reflect a reallocation.

Subsection (3) provides another method by which the Commission may coordinate the efforts of registered self-regulatory organizations, namely, by relieving a self-regulatory body of its supervisory responsibilities in relation to a person who is a member of both that organization and another one that exercises the same supervisory powers.⁵³ Concomitantly the Commission may relieve the member of his duty to comply with the organization's by-laws,⁵⁴ and it may require the organization or the member or both to notify customers and other persons doing business with the member of the reallocation of supervisory authority.⁵⁵ Presumably it will exercise the latter power only where it grants relief in an individual case rather than by regulation.

Section 9.05 thus not only brings into perspective the mixed regulatory system for supervision of the securities market under the Draft Act but also reinforces the duty of a registered self-regulatory organization to enforce its by-laws and in some cases even the provisions of the Draft Act.⁵⁶

50 See subsection (1) ("by regulation or order"); and see sections 15.19, 15.20.

51 See e.g. *Program to Reduce Duplication in Securities Industry Self-Regulation*, SEC, Securities Exchange Act Release No. 12935, October 28, 1977, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,779 (requesting submission of plans from organizations for reallocation of functions).

52 See, *In re the Montreal Options Clearing Corp.*, [1976] OSC Bull. 93, 99-101 (March).

53 Cf. *Enforcement Obligations of Exchanges and Associations*, SEC, Securities Exchange Act Release No. 12994, November 18, 1976, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,811.

54 See paragraph (3)(b).

55 See subsection (4).

56 See e.g. paragraph 9.02(3)(a).

Section 9.06

Section 9.06 ensures continuing oversight of the powers of a registered self-regulatory organization by requiring that the Commission approve all amendments to the organization's by-laws. Although the section does not expressly so provide, it is clear that a by-law cannot become effective until the Commission's approval has been obtained.⁵⁷ The openness required in connection with an application for registration under section 9.02 is continued with respect to amendments to the by-laws of a self-regulatory body. Thus the Commission must publish a notice inviting interested parties to submit written comments on a proposed amendment and cannot approve an amendment without a hearing except in the case of technical amendments.⁵⁸

Subsection (5) permits the Commission to approve technical amendments that are not likely to have a substantial impact on investors or competition policy, as is reasonably clear from the types of amendment specified in paragraphs (5)(a) to (c). Paragraph (5)(c) is intended to cover administrative matters and includes, for example, the development or amendment of procedural manuals relating to the operations of a registered clearing agency that are incorporated into the agency's by-laws. Paragraphs (5)(a) and (b) derive from the Canada Business Corporations Act and paragraphs (c) and (d) from the *ALI Code*. Both of these sources in effect allow summary approval of amendments to a fee schedule or to membership dues.⁵⁹ Subsection (5), however, omits such a provision to avoid any ambiguity concerning amendments to the fee structure of a registered organization which might result in confusion over the scope of section 9.08. Rather such matters have been left to the Commission's general exempting power under section 3.03.

Given the scope of paragraph (5)(d), however, it is clear that the Commission can summarily approve a by-law amendment that has an impact on investors or competition. The *ALI Code* deals with this matter by authorizing the Commission to convene a hearing to reconsider such a by-law within sixty days of its approval and to "abrogate" the amendment of the by-law pending its reconsideration.⁶⁰ The Draft Act avoids the complexity of a special provision permitting reconsideration as well as the time periods specified in the *ALI Code*. Instead it leaves review of a by-law that has been

57 Cf. ALI FEDERAL SECURITIES CODE, s. 805(b)(1).

58 See subsections (2), (3), (5).

59 See Canada Business Corporations Act, s. 254(3)(b); ALI FEDERAL SECURITIES CODE, s. 805(c)(1)(B).

60 See ALI FEDERAL SECURITIES CODE, s. 805(c)(3).

summarily approved to the Commission's power to require changes in an organization's by-laws under section 9.07. The procedure under that provision involves the circulation of a notice and a hearing to consider the by-law, the procedural steps omitted under subsection 9.06(5). Given the fact that a determination of the Commission is required under subsection (5) before it summarily approves a by-law, it is unlikely that there will be sufficient urgency to require another summary order declaring it ineffective before a hearing can be convened under section 9.07. If anything, this requirement should lead the Commission to exercise its powers under subsection (5) with caution where the effect of a proposed amendment is questionable.

The procedure for the approval of by-laws is a hybrid of the procedures for making orders and regulations.⁶¹ The term "order" is used in section 9.06 to make clear that where the procedure for approval of by-laws is not specified a proceeding is governed by section 15.17 and that the Commission must publish reasons for its decisions.⁶²

Section 9.07

Section 9.07 complements the Commission's supervisory jurisdiction over self-regulatory organizations by empowering it to require that the by-laws of a registrant be changed. (The term "change" rather than "amendment" is used for an alteration to an organization's by-laws that is imposed by the Commission and does not originate with the organization itself.) As under sections 9.02 and 9.04 dealing with registration, the standards for the making of such an order are specified so that the Commission may impose changes in an organization's by-laws only when they will further the purposes of the Draft Act. Subsection (2) requires that the Commission follow the notice procedure applicable to regulations when it proposes to require a change.

Section 9.08

The most sensitive issue in a cartelized or regulated market is the determination of prices. Since May 1, 1975, when fixed commission rates were abolished in the United States, the Canadian industry has been under some pressure to eliminate its fixed rate structure or to establish a rate schedule that is competitive with the prices being charged for their services by U.S. brokers. The

61 See sections 15.15, 15.17.

62 See subsection 15.17(8); and see subsection 15.20(6) (judicial review).

seriousness of this forced reconsideration of the rate structure is reflected in the number of proceedings in recent years to approve amendments to the Canadian exchanges' fee schedule and the increasingly detailed analysis of the question by the provincial commissions.⁶³ The impact of the competition from the south has led to alterations in exchange practices in related areas as well.⁶⁴ And it is likely that the pressures will continue.

Section 9.08, in recognition of the strategic importance of the price mechanism, requires separate consideration of any rate schedule proposed by a self-regulatory organization and expressly establishes clear standards to be applied by the Commission. As elsewhere in this Part, the emphasis of the section is on the elimination of unnecessary restraints on competition and the avoidance of potential abuse of self-regulatory powers.⁶⁵ Once again the Commission is given responsibility to ensure that the powers of the registered self-regulatory organizations are exercised in a manner that furthers the purposes of the Draft Act while detracting as little as possible from other government policies.⁶⁶

The section makes clear that if an organization is empowered to and does set fees for services, the fee structure shall be set out in its by-laws. And the Commission must assess the fee structure both when the organization applies for registration and when an amendment is proposed. If the fees approved by the Commission become unreasonable in the light of subsequent developments or if the justification for their impact on competition ceases to exist, the Commission may take steps under section 9.07 to require that they be changed. While the section applies to all registered organizations, it is doubtful that it will frequently be invoked in connection with an association of securities firms or a clearing agency.⁶⁷

Section 9.09

Section 9.09 parallels the other registration provisions of the Draft Act by creating an obligation on the part of a registered self-regulatory organization to admit a person to membership or

63 See e.g. *In re* Part XV of the By-Laws of the Toronto Stock Exchange, [1977] OSC Bull. 157 (July); QSC, COMMISSION RATES IN THE SECURITIES INDUSTRY (Task Force Report, June 1976); QSC, UPDATED REPORT ON COMMISSION RATES IN THE SECURITIES INDUSTRY (Task Force Report, December 1976); and see, *Williamson, Financial Institutions*, ch. III.

64 See e.g. *In re* By-Law 153 of the Toronto Stock Exchange, [1977] OSC Bull. 171 (July) (liability trading); and see, *Williamson, Capital Markets*, ch. II.D.7.

65 See paragraphs (a), (b); see also section 9.03 and Commentary.

66 See subsection 9.02(6), Commentary.

67 Cf. ALI FEDERAL SECURITIES CODE, s. 803(i)(2)(C) (by-laws of such organizations cannot impose fixed fees).

approve his employment by a member unless the standards for admission are not met.⁶⁸ The section thus reinforces the mandatory by-law provisions relating to open membership in and access to the facilities of a registrant.⁶⁹ And a fair hearing is required not only for decisions concerning admission but also for those relating to discipline. As with registration under part 8 both types of decision are treated in the same manner in order to emphasize their equivalent impact on a person's livelihood.⁷⁰ Indeed, all persons who are subject to this section must also obtain registration under part 8.

As the contents of all the permissible standards for denial of membership or employment by a member, other than those in the Draft Act itself, must be included in an organization's by-laws, the Commission will have an opportunity to deal with them in principle before they may be applied to an individual applicant.⁷¹ And if they are subsequently perceived to be unfair, the Commission may under section 9.07 require that they be changed. The standards in subsections (2) and (3) are largely self-explanatory. Those in the latter provision relate to the competence and integrity of applicants, while those in the former emphasize the policy in favour of competition that underlies the Draft Act and the protection of investors. The postamble to subsection (2), for example, precludes a registrant from excluding an applicant from membership on the basis of the volume of business or any other business carried on by it. As a result any financial institution which may carry on a securities business under its own regulatory law and which obtains registration under part 8 may become a member of a registered self-regulatory organization or a participant in a clearing agency. In other words, once the Commission has decided that registration is appropriate, the self-regulatory bodies cannot exclude the registrant from the securities business or even their specialized part of it for reasons other than those expressly permitted by subsections (2) and (3).

For similar reasons section 9.09 does not contain a standard for membership in a self-regulatory organization that is based on the ownership of the applicant. Criteria relating to foreign or other ownership of a person carrying on a securities business are to be determined by the Commission under section 8.02, in particular under subsection 8.02(4), and a self-regulatory organization may not under the Draft Act modify or alter the Commission's determinations on this matter. The Draft Act thus reflects the fact

68 Cf. sections 8.02, 9.02.

69 See paragraphs 9.03(2)(b), (3)(b).

70 See section 8.02, Commentary.

71 See subsections (2), (3); and see sections 9.02, 9.04, 9.06.

that the nationality of a registrant has nothing to do with his competence or integrity, that is, with the regulatory functions of the self-regulatory bodies, and that their application of such a standard involves an inherent conflict of interest. It embodies, therefore, the similar conclusion of the Ontario Securities Commission.⁷²

Section 9.09 establishes the procedures for denial of entry and disciplinary actions that a registered self-regulatory organization is required by paragraph 9.03(1)(f) to set out in its by-laws. Subsection (4) simply incorporates the notice and other requirements of natural justice applicable to Commission orders and hearings under section 15.17 and in this manner makes clear that such decisions of a self-regulatory body are equivalent to those of the Commission under section 8.02. The Draft Act thus ensures that a person will receive adequate notice, may be represented by counsel if he so desires, and may obtain a transcript of the proceeding should he wish to appeal the decision to the Commission under section 9.10. By this means it removes the potential for "blackballing" an applicant for membership, a remnant of the time when securities exchanges were viewed as "private clubs".⁷³

As with registration under part 8, circumstances may arise in which the delay necessary to hold a hearing in accordance with subsection (4) would be harmful to investors.⁷⁴ Subsection (6) therefore grants a power of summary suspension to a self-regulatory organization in a number of circumstances. Although the standards are again relatively straightforward, paragraph (a) requires some explanation. It permits a summary suspension of a person who has been expelled or suspended by another registered self-regulatory organization. As the paragraph refers to an organization registered under this act or a similar one, the sanction could not have been imposed on a member or employee without a procedure like that required by subsection (4). (In this context, "similar act" should be interpreted as one that imposes similar disciplinary powers *and* similar procedural safeguards.) Duplication of a hearing would therefore merely cause unnecessary delay, especially as the person who is the subject of the decision is entitled to a subsequent hearing by the second organization. It is clear from its wording that paragraph(6)(a) applies only to expulsions and suspensions that continue in effect when the summary power is invoked ("has been excluded or is under suspension"). In other words, if a member has been reinstated by the other organization,

72 See, *In re Baker Weeks of Canada Ltd.*, [1977] OSC Bull. 32, 47-48 (February); and see, *Dey & Makuch*, ch. IX.C.

73 See, *Dey & Makuch*, ch. X.D.

74 See subsection 8.02(6) and Commentary.

paragraph (6)(a) cannot serve as a basis for a summary suspension.⁷⁵

The Draft Act requires a self-regulatory organization that exercises its powers of summary suspension to provide a reasonable opportunity for a hearing within fifteen days of its decision and thus ensures that an immediate notice indicating the basis of the decision will be sent.⁷⁶ The requirement and the time period parallel those in subsections 8.02(6) and 14.04(4),⁷⁷ for while it might appear likely that a self-regulatory organization can convene a hearing more expeditiously than the Commission, it is far from clear that this is the case.⁷⁸ In any event the Draft Act provides further safeguards against an arbitrary or improper exercise of power by making a decision of a self-regulatory organization under the section appealable to the Commission and subsequently to a court.⁷⁹

Finally, any decision of a self-regulatory organization relating to discipline must be published unless the Commission specifies a type of case that need not be or grants an exemption in a particular case.⁸⁰ The requirement in subsection (5) is applicable to decisions made in accordance with subsection (4) and to summary decisions under subsection (6). It does not apply, however, to decisions favourable to a member or to those denying membership because in such cases publication would be unnecessarily punitive.

Section 9.10

Section 9.10 complements section 9.09. An affected person may appeal a decision of a registered self-regulatory organization made under section 9.09 to the Commission or the Commission may of its own motion initiate review proceedings.⁸¹ Section 9.10 requires a self-regulatory organization to notify the Commission of any adverse decision under section 9.09 and establishes the standards for review by the Commission and the orders available to it. In effect the provision does little more than codify the present Canadian practice and superimposes a requirement that the Com-

75 Cf. ALI FEDERAL SECURITIES CODE, s. 809(a)(1)(A) ("has been and is expelled or suspended").

76 See paragraph 15.17(1)(c).

77 See subsection 8.02(6), Commentary.

78 Cf. Toronto Stock Exchange, By-Law 17.13, 3 CCH CAN. SEC. L. REP. ¶ 89-734 (hearing within ten days of request which must be made within ten days of suspension).

79 See sections 9.10, 15.18, 15.19.

80 See subsection (5).

81 See section 15.18.

mission consider as well the impact on competition of any decision under review.⁸²

Subsection (1) requires a registered self-regulatory organization to file with the Commission copies of all adverse decisions made under section 9.09 along with the reasons for the decision and any other information the Commission requires. The provision is applicable both to decisions made after a hearing under subsection 9.09(4) and to summary decisions under subsection 9.09(6). It is necessary to enable the Commission to perform its supervisory functions and to determine whether to review any decision that is not appealed.⁸³

Subsections (2) and (3) establish the standards for Commission review of a denial of or imposition of a condition on membership or employment by a member and for review of disciplinary measures. In these provisions too the standards and the remedial orders available to the Commission are relatively clear. It is noteworthy, however, that on an appeal or review under either section the Commission is expressly required to consider the implications of the self-regulatory body's decision for competition policy and to apply the standard applicable to the by-laws themselves.⁸⁴ Subsection (4) makes clear that the Commission may set aside a sanction on the ground that it is unnecessarily anticompetitive in effect even if it would otherwise have affirmed the sanction under paragraph (3)(a). And paragraphs (2)(c) and (g) reinforce the importance of the role of the self-regulatory organizations in achieving the objectives specified in section 9.03 to the broader purposes of the Draft Act.

A few technical matters should be mentioned. As a result of its powers under subsection (g) to require action not specified in paragraphs (d) to (f), the Commission has broad discretion to fashion appropriate remedies under subsection (2). Under paragraph (g) it may impose further requirements and thus in effect create conditions that must be observed by a self-regulatory organization when carrying out one of the specific remedies. Paragraph (3)(a) authorizes the Commission to modify a sanction imposed for conduct that violates a by-law or a provision of the Draft Act and thus incorporates into the single standard the three included in the source provision.⁸⁵ The *ALI Code* limits the exercise of the Commission's discretion to modify to cases where the sanc-

82 See e.g. *Dey & Makuch*, ch. IX.

83 Cf. *Provision of Notices by Self-Regulatory Organizations of Disciplinary Sanctions*, SEC, Securities Exchange Act Release No. 13726, July 8, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,225 (adoption of Rule 19d-1).

84 See subsections (2), (4); cf. paragraph 9.03(4)(b).

85 See ALI FEDERAL SECURITIES CODE, s. 810(d)(2)(A).

tion is "excessive or oppressive".⁸⁶ The Draft Act, however, has no such limitation because the Commission is authorized to increase as well as to reduce a sanction. Nevertheless, it is reasonably certain that the Commission will apply the standard in the *ALI Code* when it concludes that a sanction should be reduced or remitted.

Subsection (5) is intended to protect a self-regulatory organization against civil liability arising as a result of an action taken by it in an attempt to fulfill its duties under the Draft Act, even though the decision on which its action is based is subsequently reversed. The subsection does not, however, immunize it from an order of the Commission itself or enable it to retain a fine extracted from a member pursuant to a decision that is subsequently set aside by the Commission.

Section 9.11

Section 9.11 requires each registered self-regulatory organization to appoint an auditor acceptable to the Commission and to authorize him to examine and report on its financial affairs. In order to become registered a self-regulatory organization must have the capacity and the resources to perform its duties under the act.⁸⁷ And section 9.12 authorizes the Commission to require each registered organization to submit periodic reports to enable it to maintain continuous oversight and thus to determine whether the organization continues to meet the basic statutory standards. The auditor's report on an organization's financial affairs is therefore an essential element in the Commission's surveillance of the resources of a registered organization and as such provides a cushion of protection for persons dealing with it.

The auditor's responsibilities under the Draft Act extend beyond the organization by which he is retained. Like the Canadian source provisions, subsection (2) requires a registered securities exchange and a registered association of securities firms to select a panel of auditors, each of whom is acceptable to the Commission, and an auditor from the panel must audit a member's financial affairs in accordance with the organization's by-laws. The auditor of a member must under paragraph (2)(b) report on his audit to the organization's auditor who in turn is required by subsection (3) to supply a copy of the report to the Commission on request. The organization's auditor is usually required to examine such reports and inform the organization of any problems arising out of them

86 See *id.* s. 810(d)(3).

87 See paragraph 9.02(3)(a).

as a result of which the organization may initiate disciplinary proceedings.⁸⁸ Should the by-laws of an organization not contain such provisions, the Commission may require them under section 9.07.

As a result of the importance of the functions performed by the auditor of a registered organization both in relation to the Commission's supervision of the organization and the organization's continuing supervision of its members, it is clear that, like the auditor of a corporation, his duties extend beyond those owed to his employer.⁸⁹ Under the Draft Act his responsibility is directly to the Commission and indirectly to the investing public.⁹⁰

Subsection (2) requires that the financial affairs of the members of a registered exchange or association of securities firms be audited by an auditor selected from the organization's panel.⁹¹ The provision makes clear that primary responsibility for supervision of the financial affairs of members rests with the registered self-regulatory organizations and in this regard parallels section 8.05 which gives the Commission similar supervisory powers over nonmember registrants. The Commission may ensure that the audit requirements of self-regulatory organizations are adequate through its review of their by-laws. As a result the financial stability of all registrants, whether or not members of a self-regulatory organization, is subject to continual surveillance either by the Commission or the organization of which they are members.

Subsection (2) does not, however, apply to registered clearing agencies. As participants in a clearing agency are merely persons who directly use its services, including financial institutions and members of other types of registered organization, it would not be appropriate to require that their financial affairs be audited and supervised by the clearing agency. Indeed, such supervision is not one of the functions undertaken by a clearing agency.⁹² And the "members" of a clearing agency are likely to be other self-regulatory organizations which are subject to the Commission's direct supervision if they are required to be registered under this Part.

88 See e.g. *Toronto Stock Exchange, By-Laws* 18.07, 18.11-18.12, 3 CCH CAN. SEC. L. REP. ¶¶ 89-756, 89-760 - 89-761.

89 Cf. e.g. *Canada Business Corporations Act*, ss. 155-66.

90 See e.g. *Notice II: Exchange Auditor of the Toronto Stock Exchange*, OSC Weekly Summary, February 24, 1978, at 2A.

91 See, *Dey & Makuch*, ch. III.C.

92 See e.g. sections 2.10, 2.38 and Commentary.

Section 9.12

Section 9.12 authorizes the Commission to require a registered self-regulatory organization to maintain records and to specify any reports that must be prepared and made public. Paragraph (1)(c) applies to records that the Commission may require for purposes of its own oversight needs but that are not to be made public, and paragraph (1)(d) to those that are intended to be available for public inspection.⁹³ Paragraphs (d) and (e) contain two related regulatory powers, namely, to require filing of a prescribed report and to require its dissemination to the public. However, the Commission need not require dissemination of every report that must be filed. Subsection (1) therefore enables the Commission to require a registered organization to maintain complete records of its activities and to make reports based on them public where it would be useful to investors to do so.

Subsections (2) and (3) complement the Commission's supervisory powers over self-regulatory organizations by granting it investigative powers applicable to registrants under part 9. In brief, the Commission may authorize a person to enter the premises and examine any records of a registered organization, and the organization is required to furnish any documents reasonably requested and answer any questions relating to them. The authorization is required to be in writing so that the Commission's investigator will be in a position to show without difficulty his authority under the section. The investigative powers in subsections (2) and (3) are analogous to the Commission's authority under section 14.03 to require spot audits of members of a self-regulatory organization and other registrants. Both provisions are intended to enable the Commission to investigate the affairs of registered persons, that is, of securities professionals, without invoking its full investigation powers under section 14.01.

Section 9.13

During the 1960s the New York Stock Exchange and other U.S. exchanges established contingency funds to indemnify customers of a member broker who suffered a loss as a result of the broker's insolvency.⁹⁴ However, because of the precipitate decline in the volume of trading after 1969, the failure of a number of substantial as well as marginal member firms, and the relatively small amount in the fund in relation to the volume of trading in the

93 See paragraph (1)(d) ("filed with").

94 See e.g. *Honsberger*, ch. III.B.

U.S. market, even the New York Stock Exchange was unable to satisfy all of the customers' claims against insolvent member firms. The operation of its system was, therefore, seriously criticized. Because of the large amounts of money involved, Congress took an immediate interest in the issue and after a fairly quick review of the alternatives enacted the Securities Investor Protection Act which created the Securities Investor Protection Corporation, an analogue of a bank deposit insurance corporation. The corporation, SIPC, is administered as a government agency, subject to the supervision of the Securities and Exchange Commission, but is funded by contributions from securities firms. It initially provided insurance coverage to each customer up to \$50,000 for a loss resulting from the insolvency of a securities firm subject to the act.⁹⁵ The maximum coverage was increased to \$100,000 by an amendment to the act signed into law in May 1978.⁹⁶

In response to similar pressures, the Toronto Stock Exchange established a contingency fund in 1956. And in 1968 a National Contingency Fund was established by the then four major Canadian exchanges and the Investment Dealers Association of Canada.⁹⁷ The fund is in effect a special purpose trust administered by a board of trustees who may consider claims of and make payments to customers of an insolvent member of any of the founding organizations. When a firm becomes insolvent the organization of which it was a member must reimburse the fund for three-quarters of the amount paid.⁹⁸ Fortunately, there were fewer marginal member firms carrying on business as well as a far more gradual trading decline in Canada between 1969 and 1971 so that fewer securities firms failed. The National Contingency Fund was able to satisfy the claims of customers who suffered a loss in those cases and there has been no suggestion that a body like SIPC is needed.⁹⁹

Section 9.13 therefore does not attempt to supersede the National Contingency Fund. Rather it requires registered securities exchanges and associations of securities firms to continue the fund and, as with other self-regulatory mechanisms, subjects it to the Commission's supervisory jurisdiction. Subsection (2) requires the self-regulatory bodies to file with the Commission copies of all documents relating to the fund, and subsection (1) gives it plenary authority to specify by regulation the manner in which the affairs of the fund shall be conducted, whether they involve the payment

95 See e.g. *Honsberger*, ch. III.C.

96 See Securities Investor Protection Act Amendments of 1978, Pub. L. 95-283, s. 9(a).

97 See, *Honsberger*, ch. V.B.

98 See *id.*

99 See e.g. *id.* ch. VI.6.

of customers of a bankrupt firm or the nature of the records to be kept. Subsections (3) and (4) equate the fund with other self-regulatory bodies by requiring it to appoint an auditor and prepare an annual statement and by giving the Commission investigative powers like those under section 9.12.

The Commission's key power, however, is granted by subsection (3) under which the Commission may require the National Contingency Fund to increase its reserves in order to cover foreseeable risks. The provision formalizes a residual legislative power to enable the Commission to respond quickly to an anticipated crisis in the industry. As is indicated by the requirement that the Commission first consult with the administrator of the fund and the organizations that are responsible for it, the Commission is expected to exercise its authority only where an emergency is imminent and the self-regulatory organizations are unable to obtain an increased levy from their members or to contribute to the fund themselves. The subsection thus incorporates the present arrangement whereby the organizations make payments to the fund and provides sufficient flexibility to permit an alteration of the scheme to require direct payments by the members of those organizations.

Section 9.13 contemplates one alteration to the present contingency scheme. Several of the provincial administrators have required the establishment of a contingency fund for registrants who are not members of an exchange or the Investment Dealers Association and whose customers are not entitled to claim against the National Fund.¹⁰⁰ Although the Commission could require nonmember registrants to establish a similar fund under subsection 8.02(3), subsection 9.13(1) contemplates instead their inclusion in the coverage of the National Contingency Fund and, therefore, contributions by them to its reserve fund. The Commission may readily exercise its power to impose conditions on registration under part 8 to require them to make contributions and its regulatory powers under this section to require the fund to accept them. In short, it is intended that the Commission consider the desirability of bringing all registrants under the umbrella of the fund so that all customers may be equally protected.

Section 9.14

The Commission's powers to supervise a registered self-regulatory organization are not limited to review of its by-laws and

100 See e.g. Ontario Securities Regulations, s. 6(4); and see, *Honsberger*, ch. V.B.; see also *Malczewski v. Sansai Securities Ltd.*, 49 D.L.R. (3d) 629 (B.C.S.C. 1974) (British Columbia requirement valid).

adjudicative decisions. The Draft Act places substantial reliance on the duty of the self-regulatory organizations to enforce their by-laws as well as specified provisions of the act itself in respect of their members and, on occasion, other market actors. Section 9.14 complements that duty by authorizing the Commission to sanction a self-regulatory organization for a failure to fulfill it. The Commission may thus censure an organization or suspend or revoke its registration if it violates the Draft Act or its own by-laws or if it is unable to comply with or enforce either. In the latter cases the Commission may also limit its activities under paragraph (1)(e). Although the provision empowers the Commission to impose the draconian sanctions in paragraph (1)(f), its main purpose is to furnish a broad range of remedial powers so that the Commission may apply the sanction that is most appropriate in the circumstances. For example, it is expected that the Commission would not revoke a registration unless an organization were simply incapable of performing its functions under the Draft Act. Public censure alone will often be a sufficient penalty because of the sensitivity of a self-regulatory organization to any adverse statement that affects its reputation for integrity or reflects on the fairness of its trading mechanism. And the same is true of directors, officers and employees of an exchange. Indeed, even censure by the Commission will often be sufficient to lead the organization to remove a person from office or terminate his employment.

Part 10

Clearance, Settlement and Transfer Systems

In the early nineteenth century land registration systems were developed in Germany to enable parties to a transfer of ownership or the creation of a security interest in an immovable to determine their respective rights by an entry in a register rather than by examination of a chain of title deeds. Concurrently, the analogous concept of the securities register was developed so that both an issuer corporation and a transferee or pledgee of a security might determine his rights by an entry in a securities register, thus insulating the transferee or pledgee from a claim by an intermediate holder of the security certificate between registration dates. And continental law granted additional protection to a *bona fide* purchaser for value between registration dates by characterizing a security certificate as a negotiable instrument that could be drawn in order or bearer form or restrictively endorsed, depending upon the holder's desire for security or negotiability.

Later in the same century the German banks applied these registration concepts to credit balances held for their customers, making it possible for a customer to pay his creditors by instructing a bank to debit his account and credit those of his creditors. This extension obviated the writing, delivery, clearing and settling of cheque payments and thus minimized the paper work involved in the system. In 1882 a Berlin bank extended the bank credit system to securities certificates which were usually kept in

bearer form for convenience of transfer and were in any event negotiable instruments. The technique employed was the immobilization of security certificates in a depository so that transfers and pledges among participants, like a credit transfer in the bank system, might be made by book entry in the depository.

During the 1930s and early 1940s some European governments required all securities to be placed in central depositories and to be dealt with only through their facilities so that they might have a focal point through which to control all capital transfers. The security depository systems in Germany, which had already been used for over two generations, simply continued to function after the war. In France, however, because the securities depositories were associated with the occupation government, the industry abandoned the compulsory depository system. But as a physical transfer system was insecure, slow and costly, the French government also enacted a new law to reestablish a central depository to which all participants could have access on a voluntary basis. This depository, Sicovam, has since become a cornerstone of the French securities industry.¹

The overwhelming paperwork burden that resulted from the large volume of trading in the New York market between 1960 and 1968 led the New York Stock Exchange to become interested in a securities depository that would reduce transfer costs, the number of "fails to deliver" transactions resulting from physical delays and also losses from theft of securities certificates. The New York Stock Exchange system, which became operational in 1968, was established as a wholly owned corporation, the Stock Clearing Corporation, dedicated to serving the exchange's member firms. It was sufficiently successful that other securities firms, transfer agents and financial intermediaries sought access to it. In 1973, after extensive negotiations among various members of the financial community and some prodding by Congress and the Securities and Exchange Commission, the Exchange's depository was reorganized as the Depository Trust Company (DTC) and was authorized not only to hold securities on deposit but also to hold them in trust for trust departments of banks and pension trusts. Contemporaneously, a number of federal and state laws relating to the custody of securities by financial intermediaries were amended to enable them to deposit their portfolio securities in an approved depository in order to simplify transfers and reduce portfolio storage costs. With the Securities and Exchange Commission's

1 See generally Guttman, *The Transfer of Shares in a Commercial Corporation - A Comparative Study*, 5 B.C. INDUS. & COM. L. REV. 491, 501-04 (1964).

approval, the Depository Trust Company was structured as a cooperative institution. Accordingly, the New York Stock Exchange sold a substantial number of DTC securities to the American Stock Exchange, the National Association of Securities Dealers and several other depository participants. At the end of 1975 the New York Stock Exchange still owned 61% of the shares of the company and the remainder were owned by a number of participants who were entitled to buy shares in proportion to their use of the depository's facilities.² The DTC has proved to be quite successful. By the beginning of 1977 it held on deposit securities having an aggregate market value of approximately \$111 billion; and the dollar value of book entry transfers and pledges made in 1976 totalled about \$309 billion. Altogether by the end of 1976 the depository had recorded transactions representing over \$1 trillion without having to call on its reserve for losses or on its insurer to furnish indemnity for a missing security certificate.³

Canadian law is currently undergoing the metamorphosis that changed the basic character of European securities transfer systems between 1882 and 1949. Securities registers have long been in use, based on an analogue of land registry transfer systems.⁴ Banks are currently developing and implementing credit transfer systems to obviate cheque transfers of credit balances.⁵ And a securities depository has been established and is incrementally expanding its functions to offer a number of services, including securities deposit and book entry transactions by way of transfer or pledge, cash and share settlement services, bond settlement services, interest and dividend claims settlement services, centralized clearing services for stock exchanges and, ultimately, services to permit the certificateless issue and transfer of securities.⁶

The Canadian Depository for Securities Ltd. (CDS) was incorporated under the Canada Corporations Act in 1970 and immedi-

2 See generally, *Cleland*, chs. V.C, D.

3 For information concerning the company, see the DTC's monthly newsletter and annual reports. On the development of securities depositories in North America generally, see, *Cleland*, ch. V; Baxter & Johnston, *New Mechanics for Securities Transactions*, 21 U. TORONTO L.J. 336 (1971); see also ABA COMMITTEE ON STOCK CERTIFICATES, PROPOSED AMENDMENTS TO THE MODEL BUSINESS CORPORATIONS ACT AND UCC ARTICLE 8 (1975); PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PROPOSED REVISION OF ARTICLE 8 (1977); Hoey and Rassnick, *Automation of Government Securities Operations*, 17 JURIMETRICS J. 176 (1976).

4 See e.g. Howard, *Property Registration Systems: Uniform Commercial Code, Article 8*, 6 REV. JUR. THEMIS 321, 322-30 (1971).

5 See e.g. WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION 17-19 (August 1976).

6 See e.g. *Cleland*, ch. V.

ately began to develop a comprehensive system to immobilize security certificates and permit transfers and pledges by book entry and even to permit certificateless issues and transfers as well as to provide the several ancillary services mentioned above. The CDS began its existence with a substantial advantage over the New York-based Depository Trust Company. It was founded by an association made up of most of the major actors in the Canadian financial industry, including the stock exchanges, the Investment Dealers Association of Canada and several trust companies, banks, insurance companies, and mutual funds, giving it a very broad business base. In fact, in the 12-month period between March 1976 and March 1977 the CDS recorded transactions having an aggregate dollar value of approximately \$2.3 billion.

Like the Depository Trust Company, however, the Canadian depository had to overcome not only long established institutional hurdles but also a number of legal constraints. Canadian corporation laws do not generally legitimate book entry transfers of deposited securities or certificateless issues or transfers. The one exception is the Ontario Business Corporations Act, section 91, which is based on the Uniform Commercial Code, s. 8-320, and which is, accordingly, impliedly restricted in application to a stock exchange clearing corporation. The section legitimates transfer by book entry of deposited securities but does not legitimate certificateless issues or transfers. Moreover, no Canadian law authorizes a trustee to leave a security in the custody of a depository. And no Canadian law regulates specifically the operations of a securities depository. These legal constraints would not be particularly serious in a unitary system. But because there are a number of statutes both at the federal level and in each province that regulate the activities of financial intermediaries, a large number of amendments to existing laws would be required to legitimate all aspects of a securities depository system. Alternatively, an enabling law in each jurisdiction in Canada authorizing securities market actors to use the facilities of a depository for securities might be sufficient.

Because it was too expensive, too slow and politically too complicated to seek statutory legitimacy before beginning to operate, the CDS adopted a strategy of gradual development and imposed obligations on each participant pursuant to a contract between him and the depository upon his entry into the system, thus avoiding any immediate need for a large number of statutory changes. The purpose of part 10 is to confer clear, statutory legitimacy on the operation of a comprehensive, book entry securities transfer system and thus abrogate the need to rely increasingly on complex multi-party contracts.

A securities depository comes within the definition of “clearing agency” in section 2.10 of the Draft Act and must register under part 9 before it may carry on business in Canada. Because of their close functional relationship with the major securities exchanges and their interprovincial operations, the clearing agencies in Canada, including the Canadian Depository for Securities, are significant components of a Canada-wide securities market system and fall, therefore, within Parliament’s legislative jurisdiction.⁷ Part 10 is premised on this jurisdictional base and is directed primarily at the activities of such clearing agencies. Thus although it deals with securities transfers, often of securities of provincial issuers, it focuses on the activities of a clearing agency only in respect of securities that are deposited with it. It does not attempt to require issuers to utilize the facilities of a clearing agency but is instead permissive.⁸ In other words, it enables issuers that meet the requirements of a clearing agency to choose whether to deposit their certificates with it or otherwise to avail themselves of its services, and also legitimates the practices of a clearing agency relating to securities in its custody.⁹ And once securities are deposited with a clearing agency, Parliament’s jurisdiction over the way in which they are dealt with in the system is plenary and paramount. In this manner Parliament may regulate the functions of clearing agencies without going beyond its legislative authority.

Part 10 proceeds on the basis that the Commission has sufficient supervisory authority over the structure and general market practices of clearing agencies under part 9. It focuses, therefore, exclusively on the operational aspects of clearing agencies. Thus it provides for the immobilization of securities certificates and its consequences in respect of the issue, the transfer and the pledging of securities by book entry, and for the protection of the interests of beneficial owners, pledgees and execution creditors, and it also expressly declares the rights and duties of a depository and its participants.

A number of other premises are reflected in the Part. Certificated and uncertificated security transfer systems are mutually exclusive; once a security is deposited with a clearing agency, it can be dealt with only through the agency until it is withdrawn.¹⁰ As a result, access to a clearing agency, at least for the foreseeable future, is likely to be limited to professional and institutional participants. And, because an automated depository

7 See section 9.01; and see, *Anisman & Hogg*, ch. III.C.

8 See sections 10.03, 10.18.

9 Cf. subsection 9.01(3), Commentary.

10 See e.g., section 10.12.

contemplated by part 10 is a closed, logical system, adaptation of the substantive rules and procedures relating to certificated securities would be inappropriate. Indeed, application of those rules in an automated, book entry environment would be analogous to continuing a registry of deeds to land in a computer environment.

Accordingly, like a Torrens land registry system, part 10 is constructed not as an extension of the present certificated security transfer system (as is part VI of the Canada Business Corporations Act, which is based on Uniform Commercial Code, article 8), but as a closed, alternative system that applies exclusively to securities introduced into it. Moreover, as in a Torrens system, the clearing agency is strictly liable as an insurer for any loss caused to a participant in the system by reason of its operation, except where the loss results from an extraordinary event such as a system breakdown or energy blackout that could not reasonably have been prevented.¹¹ A clearing agency will therefore have to carry adequate insurance coverage or set up a reserve for self-insurance that will enable it to fulfill its obligations to its participants.

Consistent with this approach, the Part gives a purchaser and a pledgee whose interests are entered in the records of a clearing agency that holds their securities rights equivalent to those of a holder of a bearer certificate subject to the requirement that they deal with the securities through the agency.¹² As a result a transferee who acquires a security by way of a book entry transfer acquires it free from any lien of the issuer, any restriction on transfer, or any adverse claim of a holder who previously owned and held it in certificated form. These claims are cut off when the security is entered in a book entry system to which part 10 applies, unless expressly preserved by way of a blocked account.¹³ If a clearing agency wrongly admits a certificated security into the system, it is liable to the previous, rightful owner and its only recourse is against the person who improperly deposited it into the system (and not against a person who subsequently acquires it within the system).

Although partly influenced by the German book entry systems, part 10 was largely based in principle on the General Regulations Governing United States Securities of the United States Department of the Treasury.¹⁴ The General Regulations were in turn based on the original Uniform Commercial Code, article 8, and have been used successfully since 1968 to effect each year the

11 See section 10.16.

12 See sections 10.05, 10.07 and Commentary.

13 See *e.g.* section 10.06.

14 See Departmental Circular No. 300 (4th rev. March 9, 1973).

transfer of securities having a face value of billions of dollars. Although that system relates to the securities of only one issuer, the United States Government, there appears to be no reason why it cannot be applied to the more complex market for corporate securities. Indeed, like a Torrens land registry system, it is simple, elegant and effective.

Given the inherent complexity of an electronic securities transfer system, any attempt to anticipate its structure and operation and to embody its basic characteristics in a statute would undoubtedly prove futile. Rather than attempt to force a modern computer-communications system into what would inevitably become a statutory procrustean bed, the Draft Act gives the Commission broad powers to deal by means of regulations with substantive operational issues as they arise.¹⁵ In this regard it adopts the model of the U.S. Second Liberty Bond Act¹⁶ under which the Department of the Treasury regulates trading in government bonds. Part 10 thus attempts to establish a legal framework that confers clear rights on participants who trade through the facilities of a clearing agency and that adequately protects the interests of investors without unduly limiting the operational development of clearing agencies. The exercise of the Commission's power to make regulations in furtherance of these goals is reinforced by the procedural provisions applicable to regulations under part 15.

Section 10.01

Section 10.01 complements the general policy goals of the Draft Act specified in section 1.02 and especially those in paragraphs 1.02(d) and (e). A separate and more detailed statement of purpose is included in this Part in order to highlight the importance of clearing and transfer systems to the functioning of the Canadian securities market and to provide a clearer policy direction for the Commission in exercising its power to make regulations to govern the operational aspects of clearing agencies.¹⁷

Section 10.02

Section 10.02 contains a number of definitions that are peculiar to this Part. Most are self-explanatory but two merit particu-

15 See subsection 10.18(3).

16 31 U.S.C.A., ss. 752-54.

17 See subsection 10.18(3) and Commentary.

lar attention. The concept of a "blocked account" is central to part 10 in that it provides a means of enabling a person other than a participant to control the transfer of securities in a clearing agency. A beneficial owner, pledgee or judgment creditor of securities may therefore ensure that the broker or other financial actor in whose name the securities are deposited with an agency cannot transfer them without his permission. The establishment of a procedure to permit and govern trading in such accounts is required by section 10.06.

The definition of "pledge" serves a similar function. It is cast in broad conceptual terms to define a possessory security interest in a security regardless of the legal characterization of the contractual relationship between the parties and provides a basis for one type of blocked account.¹⁸ The broad functional definition avoids any undue restrictions on the availability of such accounts to persons who may have a legitimate interest to protect.

A number of definitions in part 2 of the Draft Act are especially important to this Part, namely, those of "beneficial owner", "clearing agency", "issuer", "participant" and "securities register".¹⁹

Section 10.03

Canadian mutual funds have for a number of years dispensed with the issue of certificates to avoid the expense of repeatedly issuing and redeeming them and instead have issued confirmations stating that a securityholder is entitled to receive a certificate on demand. Subsection 45(1) of the Canada, Manitoba and Saskatchewan Business Corporations Acts legitimates this practice for all corporations subject to those acts, including mutual funds, by empowering a corporation to issue a non-transferable acknowledgement instead of a security certificate to a securityholder subject to his right to demand a certificate at any time.

Section 10.03 goes a step further and authorizes any issuer to issue a certificate directly to a registered clearing agency to be held on deposit for the beneficial owner or, alternatively, to dispense with the issue of a certificate altogether and issue a security to a beneficial owner by concurrent book entries in its securities register and the records of the clearing agency. The provision is permissive in that it enables issuers to avail themselves of a clearing agency's facilities. A corporation may do so under subsection

18 See section 10.07.

19 See sections 2.06 ("beneficial owner"), 2.10 ("clearing agency"), 2.21 ("issuer"), 2.28 ("participant"), 2.44 ("securities register") and Commentary.

(1) because it has clear authority to send a certificate to any person whom the owner designates. However, whether it can do so by means of book entries under subsection (2) is a matter of corporate law and, like similar issues in connection with part 7, is left to the determination of the incorporating legislature.²⁰ In any event a securityholder may always deposit a security with a clearing agency through a participant.

The section permits an issuer to issue securities to a registered clearing agency. As the provision concerns the initial deposit of securities, it limits the authority to a registered agency and thus reinforces the requirement of section 9.01.²¹ Because the remaining provisions of the Part deal with the business activities and relationships of clearing agencies, their application is not so limited. Rather they apply to all clearing agencies so that even a clearing agency that carries on business in violation of section 9.01, that is, without being registered, must comply with the substantive provisions. A clearing agency cannot, therefore, escape the duties imposed by part 10 merely by failing to register.

As the provision applies to "any issuer", it is not limited to reporting issuers. Although it is expected that the majority of issuers that make use of a clearing agency will have registered under part 4, the section does not preclude non-reporting issuers from doing so. Thus an issuer that makes a distribution to which part 5 applies may have its securities deposited with a clearing agency even before it has 300 equity securityholders of record. And the securities of non-reporting issuers sold pursuant to an exemption in part 6 may also be deposited provided the requirements of the clearing agency are met. In light of the permissive nature of the provision there is neither a constitutional nor a policy basis for limiting the provision to reporting issuers.

The formalities in respect of the two systems permitted under subsections (1) and (2) necessarily differ. When a certificate is issued under the former subsection, an entry is automatically made in the issuer's securities register. However, as no certificate is issued when the procedure in subsection (2) is followed, the Draft Act imposes a duty on both the issuer and the clearing agency to make concurrent entries in their records, that is, in the issuer's securities register and in the agency's records.

These procedures would be cumbersome if individuals were to have direct access to a clearing agency. They are predicated, however, on the likelihood that only financial intermediaries and not individual investors will be permitted to open accounts in a

20 *Cf.* subsection 10.18(1) and Commentary.

21 *See also* subsection 10.18(1).

clearing agency. As a result the procedures in section 10.03 will probably apply only to private placements to regulated financial institutions²² and to distributions to the public of new issues of securities. In the latter case the required documents will be executed by the issuer, the clearing agency and the lead underwriter who will be the initial beneficial owner of the issued securities. The documents will presumably include any warranties given by the issuer to the clearing agency or underwriter and transfers will be entered in the agency's records as the securities are distributed to members of the underwriting and selling groups.

The Depository Trust Company in New York has participated in a number of new issues, using a procedure analogous to that in subsection (1), namely, immediate immobilization of a block security certificate. In the January 1977 issue of its newsletter the DTC reported that with respect to an issue of 1.6 million common shares of Wisconsin Electric Power Company only eleven certificates representing 924,000 shares were issued to it and 529 certificates for the remaining 676,000 shares were physically issued to underwriters or brokers who were not participants in its system. The issuer estimated that it avoided issuing between 2,000 and 3,000 certificates at the time of original issue and a further 5,000 to 6,000 as the issue came to rest in the hands of public investors.²³ It is clear that when used in connection with a distribution of a new issue of securities, the system eliminates an enormous amount of repetitive paper work, avoids inevitable data-processing errors and expedites dramatically the mechanics of distribution. Although it has not yet participated in a distribution, the Canadian Depository for Securities will initiate a "new issue" service in January 1979.²⁴

Subsection (3) declares that an issue of securities by means of concurrent entries in an issuer's securities register and an agency's records pursuant to subsection (2) has the same effect as delivery to the clearing agency of a security certificate in bearer form, thus giving the clearing agency unimpeachable legal title to the underlying securities referred to in the entry. A similar provision is also included in subsection 10.04(5) with respect to a certificateless issue that is not part of a distribution, in subsection 10.05(2) with respect to transfers by record entry, and in subsection 10.07(2) with respect to pledges by the same means.

22 See paragraph 9.03(3)(b).

23 See also, *Cleland*, n. 86.

24 See *id.* at n. 86 and following.

Section 10.04

Some corporation laws in Canada still permit a corporation to issue a security subject to calls, that is, to issue a security for less than its stated value subject to receiving payments up to that value in amounts and at times to be determined by the corporation's directors.²⁵ A holder of a security so allotted is not the absolute owner of it because the corporation can invariably declare the security forfeit for a failure to pay a call.²⁶ And the listing of such securities is prohibited by securities exchanges because of the restrictions on transfer that normally are attached to them.²⁷ The refusal to list has the additional merit of protecting investors who might unknowingly purchase partly paid securities.²⁸ For the same reasons subsection (1) precludes a clearing agency from allowing a security subject to calls into its system.

Subsections (2) and (3) are designed to prevent the accumulation of a "float" of securities that have been submitted to a clearing agency for entry in the system but not presented to the issuer for registration of transfer in the clearing agency's name. Because a large number of transfers may be made by book entry shortly after a security is deposited with a clearing agency, it is in the best interests of all parties to have the clearing agency become the registered owner of the security as quickly as possible. The clearing agency must acquire a valid security to ensure that its general ledger account for that class of securities can be reconciled at all times with the subsidiary ledger accounts of its participants who are owners of securities of that class in case any certificate in its possession is counterfeit or recoverable by a previous holder. Subsection (2) therefore imposes a duty on a clearing agency to seek registration of a transfer immediately and subsection (3) places a corresponding duty on the issuer to register the transfer to the clearing agency.

Subsections (3) and (4), like the parallel provisions in section 10.03, permit the parties to determine whether a certificate should be issued or the transfer recorded by book entries. They do not, however, relate to a distribution of securities but to a deposit of previously issued securities with the clearing agency.

25 See *e.g.* Canada Corporations Act, ss. 35–36, 40, 44–48; compare Canada Business Corporations Act, s. 25.

26 See *e.g.* Canada Corporations Act, s. 46.

27 *E.g. id.* s. 40.

28 See *e.g. id.* s. 40(4) (transferee liable for unpaid calls).

Section 10.05

Section 10.05, although brief, is the keystone of the depository system under part 10 in that it legitimates the transfer of ownership of a security from a seller to a purchaser by book entry in the records of the clearing agency. Once a security is transferred, the transferee participant, subject to the agency's right under subsection 10.16(3) to correct an error, is entitled to withdraw the security from the depository under section 10.13 and to instruct the agency to transfer it to yet another participant under this section. And the clearing agency is liable to him for its own errors under section 10.16. In short, sections 10.05, 10.13 and 10.16 in combination have the effect of giving a transferee participant unimpeachable ownership of the security transferred to his account in the agency's records. This result is made clear by subsection (2).

Section 10.06

Section 10.06 introduces the novel concept of a blocked account to avoid the need to make an outright transfer of a security on a clearing agency's records from a beneficial owner to a person who has an interest in the security. By requiring a clearing agency to establish procedures for blocked accounts, the section in effect permits such a person to maintain control over the account by preventing the transfer of a security held in it until his interest in or claim against it is satisfied. Subsection (2) makes clear the effect of blocking an account; it prohibits a clearing agency from dealing with a security held in it without instructions from the person on whose behalf it is blocked, except where it does so to correct an error pursuant to subsection 10.16(3). Subsection (2), in conjunction with section 10.05, thus gives a person who exercises control over an account sufficient power to protect his interest. It does not, however, make him the owner, for the security remains in the account in the participant's name. As a result, until a pledgee or judgment creditor actually realizes the security in which he has an interest, materials from the issuer, including dividend cheques and disclosure documents, will continue to flow through to the participant and thus to the beneficial owner.²⁹

Paragraphs (1)(a) and (b) specify the persons on whose behalf and the circumstances in which a blocked account may be created. The duty to establish such accounts and the circumstances in which it arises are specified in sections 10.07 to 10.11. The applica-

29 See section 10.14.

tion of the blocked account concept is, therefore, discussed more fully in the commentary to those sections.

Section 10.07

“Pledge” is defined in section 10.02 in broad terms to mean any kind of possessory security interest in a security however it is designated. Section 10.07, complementing section 10.05, legitimates a transfer of a security to effect a pledge by means of a book entry in a clearing agency’s records that gives a lender a security interest in the security beneficially owned by a pledger and maintained in the clearing agency’s system.

A pledge may be effected by an outright transfer to the pledgee or, if the parties so agree, by setting up a blocked account in the name of a participant who acts on behalf of the beneficial owner but over which the pledgee exercises control. In the former case the security is transferred to the pledgee’s own account, if the pledgee is an institution that is a participant in the clearing agency, or to the account of the participant representing the pledgee; thus the pledgee in effect takes actual possession of the security. If, however, a blocked account is set up in his favour, the pledgee is entitled to control the transfer or any other dealing with the securities in the account as specified in section 10.05 and subsection 10.06(2), but the securities remain in the account of the pledger’s participant. In either case the pledgee acquires a possessory security interest that is not subject to the registration requirements of any provincial law relating to the perfection of non-possessory security interests in movables.

Subsections (3) and (4) make a clearing agency virtually immune from any claim for damages in a conversion action where a pledgee wrongly realizes a security in which he claims a security interest. Subsection (3) requires a clearing agency to transfer securities on the instructions of a pledgee alone unless it knows that he is not entitled to them or unless its procedures governing blocked accounts require otherwise. An agency’s procedures might specify conditions beyond the requirements of subsection (3) as prerequisites to the realization by a pledgee of the securities in the account, for example, by requiring the concurrence of the participant in whose name the account is entered. In such circumstances, it would be an easy matter for a clearing agency to require compliance. Nevertheless, subsection (4) immunizes a clearing agency from liability for loss resulting from its compliance with a pledgee’s instructions unless it transfers the securities with knowledge that the pledgee is not entitled to them. Although admittedly confined, this provision is designed to permit continu-

ance in the clearing agency context of existing securities market procedures for margined securities, that is, securities bought by making a down payment and pledging the securities themselves to secure the unpaid balance of the purchase price. If the customer fails to maintain the agreed amount of margin, the broker or other pledgee is invariably entitled under the agreement with him to realize the margined securities.³⁰

A pledge may also be made through a clearing agency to secure a loan that is not connected with a purchase of securities. In such a case, the parties may determine by contract the pledgee's rights to deal with the pledged securities. If the beneficial owner wishes to ensure that the pledgee cannot realize the securities unilaterally, he may stipulate that the pledge be effected by creating a blocked account controlled by him but in the pledgee's name if it is a participant or alternatively in the name of a participant representing the pledgee. In this manner the borrower will be entitled to the rights under section 10.05 and subsection 10.06(2) and will be in a better position to protect his own interests. Alternatively, subject to the Commission's approval under subsection 10.18(3), a clearing agency may establish a procedure permitting double blocking of an account so that both the pledgee and the beneficial owner would have to approve any transfers.

Section 10.08

Securities firms hold many millions of dollars of securities for customers, usually in a form that complies with stock exchange delivery requirements, that is, in "street form", so that they may be traded upon receipt of telephone instructions from a customer. A street form certificate is almost always in the name of a securities firm and endorsed by one of its officers whose signature is in turn usually guaranteed by a financial intermediary such as a bank. A firm may hold a security in a manner that identifies it as property of a specific customer or in segregated bulk, separate from the firm's own portfolio but in a manner that precludes identification of any security of a class as that of a specific customer. The latter method of holding securities is especially common where customers buy securities on margin because the margin contract invariably gives a securities firm broad power to pledge or realize the margined security. Where a securities firm is a participant in a securities depository it will ordinarily hold all securities of customers in a depository account maintained in the

30 See e.g. *Honsberger* at nn. 47-50.

firm's name and that account is its segregated bulk account of securities held for customers.

Because of the enormous number of accounts that would be required, it is unlikely that individuals will be permitted to participate directly in a clearing agency unless they are within a specific class, presumably of very large and active traders, designated by the Commission under paragraph 9.03(3)(b). Rather, customers will have only indirect access to a depository through a securities firm or other participant. And a firm that holds customers' securities in its general account will ordinarily have power to transfer or pledge them. In fact in most circumstances a securities firm will not wish to hold a security for a customer in any form that does not permit efficient transfer, for any unnecessary formalities required to complete a trade may make it unprofitable to the firm.

There may be cases, however, where a customer wants to retain residual control over securities held by a depository in an account in a firm's name. Section 10.08 therefore permits creation of a blocked account in favour of a beneficial owner. Thus a trust company that is not itself a participant or a trustee for an estate may maintain control over securities held in trust by means of a blocked account and may thus insulate them from the effects of a bankruptcy of the securities firm in whose name the account is established.³¹

Unlike section 10.07, this section does not require a clearing agency to set up a blocked account. The procedure is mandatory under the former provision because the pledge is a device that must be accommodated if a depository is to operate successfully. Compliance by a clearing agency with a court order obtained by a judgment creditor is similarly mandatory under section 10.10. However, the question of whether a blocked account set up to give residual control to a beneficial owner or to restrict the transfer of securities is sufficiently necessary to warrant the administrative difficulties associated with its establishment is left to the clearing agency subject to the Commission's supervisory approval.³² It is likely that once a procedure for blocked accounts is established for pledgees and judgment creditors, its extension to the situations dealt with in this and the succeeding section will not create substantial difficulties. Nevertheless, there may even be cases concerning pledgees and judgment creditors where the Commission considers it appropriate to exempt a clearing agency from the requirements of section 10.06, 10.07 and 10.10.³³

31 See generally, e.g. *Honsberger*, chs. II, III.A, V.C.

32 See subsection 10.18(3).

33 See section 3.03 and *Commentary*.

Section 10.09

A clearing agency will ordinarily refuse to accept a security that is subject to any restrictions on its transfer in order to facilitate the transfer of securities in its system without its having to obtain third party clearance or to make a decision about the legality of a proposed trade. There may, however, be particular cases where a clearing agency will be willing to accept such a security as a special service to a customer. The most probable example is a security acquired by a participating financial institution in an exempt distribution pursuant to section 6.02 during the period when the security cannot be distributed to the public without complying with part 5.³⁴ Without this technique, an agency might have to refuse to accept any securities subject to such a restriction in order to avoid the possibility of inadvertently participating in an improper distribution. Section 10.06 anticipates the situation where a clearing agency may itself wish to control securities in an account in its records, and section 10.09 gives it the substantive power to do so.

The section is not limited to restrictions on transfer. It also permits a clearing agency to develop procedures for handling other types of limitations on securities dealing or ownership. Paragraph (1)(b) thus includes securities the transfer of which is "constrained". The concept of constrained securities relates to limitations imposed by statute or otherwise on the number of securities of an issuer that may be owned by a person of a particular class. The obvious example is the key sector legislation in Canada relating to financial institutions.³⁵ The concept is also included in the Canada Business Corporations Act, s. 168, to permit corporations to comply with the requirements of regulatory legislation to which they may be subject.³⁶ As an issuer comes within the definition of "interested person" in section 10.02, a clearing agency may wish to develop a service that will enable issuers to enforce such constraints. Section 10.09 permits it to do so, subject, of course, to the Commission's approval under subsection 10.18(3).

Section 10.10

As the securities register was developed as an analogue to the land registry system, it is not surprising that the courts have

34 See paragraph 2.17(b) ("distribution") and Commentary.

35 See e.g. Canadian and British Insurance Companies Act, R.S.C. 1970, c. I-15, ss. 18-22.

36 See also Canada Business Corporations Regulations, ss. 51-57.

developed policies concerning the right to execute against corporate securities that parallel the right to execute against land registered in a Torrens system. Where land transfers are effected by registration under a Torrens system, a judgment creditor may realize against the land only by formal execution proceedings under the apposite execution act. Pending execution, however, he is entitled to register his judgment in the land registry office and thus give constructive notice of his right to have the land sold in satisfaction of his judgment to all persons who subsequently deal with it. As a result his right takes priority over subsequent claims. There is in general no conflict between an execution creditor and a subsequent *bona fide* purchaser for value, for the purchaser buys only on the basis of a registration of transfer of the land to him and not on the basis of any deed delivered by the putative owner.

Similarly, at common law a judgment creditor could serve notice on a corporation that he had a judgment against a shareholder (usually in the form of an equitable charging order) and request the corporation, on tender of the shares by the judgment debtor, to issue new security certificates to be sold in execution proceedings to satisfy his judgment. The corporation, upon issue of the new shares in accordance with the charging order, cancelled the old shares and thus extinguished the rights attached to the shares of the judgment debtor or of any person who acquired title through him. It is probable, but not altogether clear, that the charging order could not affect the rights of a *bona fide* purchaser of the securities. But in any event, because security certificates, irrespective of their conceptual or legal nature, were in fact perceived in the securities market to be negotiable instruments, the common law created a possible conflict between the rights of a *bona fide* purchaser of the securities from a judgment debtor and the rights of a judgment creditor.

To resolve this impasse, early in this century the State of New York enacted a statute declaring that execution against a security could be effected only by physical seizure of the security certificates representing it. This policy is continued in *Uniform Commercial Code*, s. 8-317, and has been accepted by nearly all jurisdictions that have adopted the model in the code.³⁷ Two notable exceptions are Delaware and Ontario where, presumably, execution may still be effected by means of a charging order and thus may prejudice the rights of a *bona fide* purchaser.³⁸

In order to ensure that a securityholder cannot insulate his

37 See e.g. Canada Business Corporations Act, s. 70.

38 See generally Woolever, *Providing an Effective Remedy in Shareholders' Suits*

securities from execution by depositing them in a clearing agency, section 10.10 establishes a procedure empowering a court, upon the application of a judgment creditor, to order a clearing agency to block an account in the name of a judgment debtor or his agent. In most cases the account will be in the name of a participant acting as agent of the debtor in connection with the deposit of the securities in the clearing agency. In effect, the section enables an execution creditor to freeze securities held in a clearing agency for his judgment debtor until he can complete formal execution proceedings to obtain them. And subsection (2) requires a clearing agency to deliver them up after he has done so.

Subsection (3) is an analogue of the *lis pendens* or caveat procedures under the land registry acts and empowers a court to prevent any dealings with a security until a dispute concerning its ownership is resolved. Most such disputes may be handled by a summary application under section 10.17. As a result, unless the matter is complex and the proceedings protracted, an order under subsection (3) will usually have a short duration. Subsection (4), like the analogous provision in subsection 10.07(3), ensures that a clearing agency will not incur liability by obeying an order of a court under this section.

Section 10.11

Sections 10.03 to 10.10 define the functions of a clearing agency. Sections 10.11 to 10.17 attempt to clarify the legal relationships among the issuer and beneficial owner of a security, a securities firm and a clearing agency. Subsection 10.11(1) thus unequivocally characterizes a clearing agency as an intermediary or mere nominee that may hold a security for a beneficial owner or his agent. The clearing agency's only rights against the issuer are to become entered in the issuer's securities register as registered owner of the security and to demand a security certificate representing it. The clearing agency has no right against an issuer to demand a notice of meeting, to vote, to demand payment of a dividend, or to participate in a liquidation distribution. Rather the beneficial owner remains entitled to each of these rights to the same degree as he would if his securities were not held in a clearing agency. That the Part does not affect the position of a beneficial owner in relation to the issuer is made clear by section 10.14 which ensures that materials sent to securityholders by an issuer pursu-

against Officers, Directors and Controlling Persons, 9 U. MICH. J.L. REF. 115, 116-119 (1975).

ant to part 7 or otherwise are received by the beneficial owner or his agent.³⁹

Subsection (2) is the obverse of subsection (1); it limits the duties owed to a clearing agency by an issuer to those specified in the preceding subsection. Subsection (3) rounds out the pattern by declaring that a clearing agency is not a beneficial owner of a security registered in its name. It is clear, therefore, not only that the beneficial owner of a security retains any rights to which he would otherwise be entitled but also that a clearing agency does not acquire a status resulting from the percentage of securities held, for example, that of an insider or a holding corporation, merely because its name is included as registered owner on an issuer's securities register.

Section 10.12

Section 10.12 is designed to dispel any illusions that a security-holder may deal with a security that is on deposit with a clearing agency in any manner other than through the agency's facilities. If a beneficial owner wants to deal directly with a security, for example, to pledge the security with a lender who is not a participant of the clearing agency, he must, through his participant, withdraw the security pursuant to section 10.13 in order to deliver a certificate to his lender. The provision thus underlines that a confirmation sent to a beneficial owner or his agent under section 10.03 or 10.04, like a certificate of title issued in a Torrens land registry system, is not itself a title document but only a non-transferable voucher that evidences his claim to a security. The section, however, constrains only a participant's right to transfer securities held by him without going through the clearing agency's system. It does not, for example, prevent him from recording in his own records a transfer of a security from one customer to another if the security is held in his bulk segregation account maintained for all of his customers in the clearing agency.

Section 10.13

Section 10.12 requires a participant who deposits a security certificate in a clearing agency to deal with it through the agency's facilities while it is in its custody. Section 10.13, a logical corollary of that provision, entitles a participant to withdraw a security from a clearing agency at any time and imposes on the clearing agency a duty to deliver a security certificate to the

39 *See especially* subsection 10.14(10).

participant within a reasonable time. The “reasonable time” standard is employed to allow the clearing agency time to obtain a security certificate from the issuer and deliver it to the participant. Subsection (2), which parallels subsection 10.04(3), requires an issuer to furnish a security certificate upon the demand of a clearing agency so that the clearing agency may fulfill its statutory obligation to a participant.

Section 10.14

The sending of notices of meetings, proxy circulars, takeover bid circulars and dividend cheques to beneficial owners of securities of widely held issuers has long created problems because many of the securities of such issuers are held by securities firms in street form. Under corporation law a corporation is invariably entitled to presume that a registered owner of its securities is the owner for all purposes and to send the material to him. It may therefore send all notices, documents, and dividend cheques to the securities firm that appears on its register. To ensure that a securities firm does not become a bottleneck with respect to the distribution of such materials, the provincial securities laws generally prohibit the voting of securities unless a firm sends the relevant materials to the beneficial owners.⁴⁰ The Draft Act contains a similar provision requiring registrants to forward all materials to the beneficial owners of securities held by them.⁴¹

The problem is compounded in a clearing agency context where two nominees are interposed between the issuer and a beneficial owner of its securities. Because sections 10.03 and 10.04 require that a clearing agency be recorded on the issuer’s books as the registered owner of securities held by it, some further method of ensuring that beneficial owners will receive documents sent by their issuer is necessary. Section 10.14 attempts to provide it by imposing on an issuer a duty to obtain a list of participants from a clearing agency and by requiring a clearing agency to furnish the list within seven days. In light of sections 10.03 and 10.04 an issuer should have no difficulty in making such a request; all clearing agencies holding its securities will appear on its securities register, and the seven-day period in subsection (2) should provide sufficient time for a clearing agency to prepare a list so that the issuer can send out its documents within the periods prescribed by the relevant corporation law.

40 See *e.g.* Ontario Securities Act, s. 80; Canada Business Corporations Act, s. 147; and see Ontario Securities Act, 1978, s. 48 (prohibiting voting without instructions).

41 See section 11.05 and Commentary.

Subsections (1) and (2) thus enable an issuer to obtain a list of participants, that is, of securities firms and of financial institutions that own the securities held for them by a clearing agency. Subsections (3) to (5) deal with the former type of participant. A clearing agency is required to send a notice of a demand from an issuer, when it receives it, to all participants that are securities firms so that they may in their turn send a list of beneficial owners to the clearing agency or to the issuer itself (subsection (4)). If a securities firm fails to furnish such a list or does not include in a list that is sent all of the beneficial owners for whom it is a nominee holder of the issuer's securities, it must obtain from the issuer the documents for which the list was requested and send them, at its own expense, to the beneficial owners who have not previously indicated that they do not wish to receive such material.⁴² The effect of the provision is to place some pressure on securities firms to furnish a list under subsection (4).

Subsections (6) and (7) are designed to ensure that no person will obtain access to a securities firm's customer list because it complies with subsection (4). Subsection (6) requires a clearing agency to consolidate all lists received by it in a form that precludes association of a beneficial owner with a participant before sending them to an issuer in order to protect the confidentiality of the participant's customer list. Because the procedure benefits the participants who submit lists, the clearing agency is authorized, subject to the Commission's approval, to charge them a reasonable fee for the consolidation.

The Securities and Exchange Commission completed an extensive analysis of this problem in 1976.⁴³ In 1977, however, it decided not to adopt a policy analogous to section 10.14 that would apply in the present context of certificated securities on the ground that it was not administratively feasible at reasonable cost to integrate the many diverse computerized files of issuers and securities firms.⁴⁴ As section 10.14 is limited to the context of a clearing agency, it is expected that the clearing agencies, issuers and all participants, including securities firms, will of necessity adopt uniform data definitions and file structures so that the

42 Cf. section 11.05.

43 See SEC, FINAL REPORT ON THE PRACTICE OF RECORDING THE OWNERSHIP OF SECURITIES IN THE RECORDS OF THE ISSUER IN OTHER THAN THE NAME OF THE BENEFICIAL OWNER OF SUCH SECURITIES, H.R. Comm. on Interstate and Foreign Commerce, 94th Cong., 2d Sess. (Comm. Print 1976).

44 See, *Requirements for Dissemination of Proxy Information to Beneficial Owners by Issuers and Intermediary Broker-Dealers*, SEC, Securities Exchange Act Release No. 13719, July 5, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,221 at 88,275-76.

several computerized files may be sorted and merged at reasonable cost.

Subsection (10) completes the pattern of the section by enabling an issuer to treat a person named on a list under this section, whether it be a participant or a beneficial owner who acts through a participant, as the owner of the securities. The subsection thus authorizes an issuer to rely on the lists received and increases the likelihood of the actual beneficial owners receiving the materials required by the Draft Act.⁴⁵

Section 10.15

Where an issuer's securities are widely held and actively traded it is likely that a clearing agency will be shown on its securities register as the holder of many, even most, of its securities. To ensure that a securityholder or a person intending to solicit proxies or make a takeover bid will not be prevented from obtaining access to a list of participants, section 10.15 gives such persons a right of direct access to the relevant records of a clearing agency that holds the issuer's securities in addition to the right invariably conferred on them by the corporation acts.⁴⁶ The section does not include the constraints that are usually included in the corporation laws to prevent improper use of a list of securityholders because only the names of participants will be included on a list obtained under it, and in most if not all cases the participants will be institutions and securities firms. Nevertheless, for that reason alone a list under this section may be valuable to an offeror who intends to engage in warehousing before making a takeover bid.⁴⁷

Section 10.16

From the point of view of a clearing agency section 10.16 is of fundamental importance, for it delimits the liability of the clearing agency both in respect of a specific error and in respect of an extraordinary event that renders its entire system inoperable.

As in a Torrens land registry system, the entries on the records of a clearing agency govern the rights of the participants. Thus an error by a clearing agency does not affect the validity of a transfer of a security from one account to another (subsection (1)), and the clearing agency is liable as an insurer under subsection (2) for the erroneous transfer. Pursuant to subsection (3),

45 See e.g. part 7. And see generally Note, *Comprehensive Securities Depository Systems and the Beneficial Owner*, 20 U.C.L.A. L. REV. 348, 375-81 (1972).

46 See e.g. P. ANISMAN at 61-63.

47 See generally *id.* at 108-44.

however, the clearing agency may correct any such error to the extent that there are securities of the same class in the transferee account. Nevertheless, a clearing agency will be liable if it admits into its system a security evidenced by a forged or counterfeit certificate, if it fails to prevent a misappropriation by its employees, or if it simply loses a security in its system. An aggrieved person need only prove that he has a valid claim against the clearing agency, which he may do by means of the written confirmation of the transaction received under section 10.03 or 10.04.

Subsection (4) is a further qualification of the strict liability of a clearing agency. It relates not to an error in the operation of the system but to a breakdown of the overall system itself, whether caused by an extraordinary system failure or some cataclysmic event such as a major storm, earthquake or war. In such a case the liability of a clearing agency may be more closely assimilated to that of a common carrier, which is an insurer of goods carried by it except where their loss is caused by an act of God. Without such an escape valve, a clearing agency would often be rendered insolvent by a catastrophic event, whereas under the subsection a loss from an overall system breakdown will be spread throughout the financial industry. Subsection (4) therefore focuses on a clearing agency's capacity and conduct and enables it to escape liability for an extraordinary system failure where it shows that it took reasonable corrective action.

Section 10.17

Section 10.17 confers standing on any interested person to apply to a superior court for an order requiring rectification of an alleged error in a clearing agency's records.⁴⁸ The usual type of error will likely relate to an erroneous transfer or pledge or the entry of the wrong name in an account that a clearing agency refuses to correct. Indeed the provision envisages such a situation and gives a clearing agency itself standing to seek a determination of a court as to the action it should take. Subsection (2) authorizes a court on an application under the section to make an order that is appropriate in the circumstances. For example, under paragraph (2)(g) it may assess damages against a clearing agency if an error cannot be corrected in accordance with the standard in section 10.16. And paragraph (2)(g) is sufficiently broad to permit a court to require a party to the application to compensate a clearing agency for any damage caused to it.

48 See subsection 16.05(1) and Commentary.

Section 10.18

In view of the fact that a comprehensive clearing agency is a central element of an electronic securities market, exclusion from access to the services of a clearing agency may be tantamount to exclusion from the securities industry. Paragraph 9.03(3)(b) therefore imposes a duty on a registered clearing agency to admit as a participant any person who satisfies the standards specified in section 9.09. The onus is thus placed on a clearing agency to justify a refusal.

Subsection 10.18(1) complements this policy by authorizing a registered clearing agency to hold securities for financial institutions. The provision adopts a permissive approach similar to that in section 10.03 because many of the institutions to which it would apply are incorporated under provincial legislation which governs their handling of portfolio securities and securities held by them in trust.⁴⁹ Before such institutions could deposit securities in a clearing agency, the provinces would have to amend the laws governing their investment practices. Subsection (2), however, empowers the Commission to grant authority to federally incorporated institutions to become participants in order to obviate the need for a multitude of amendments to federal statutes.

Subsection (1) is an analogue of the legal model adopted in New York in 1973 to give the Depository Trust Company the status of a trust company so that it might hold securities for trustees who would otherwise have been reluctant to give up possession or control of securities certificates for fear of being found liable for a breach of trust if the security were lost by the clearing agency.⁵⁰ Thus a registered clearing agency impliedly has the capacity of a trustee and may hold securities for a person who himself holds them in trust.

Finally, subsection (3) confers broad powers on the Commission to approve any aspect of a clearing agency's operating system. The provision complements the Commission's supervisory powers under part 9, which deal primarily with the constitutional framework within which a clearing agency is required to operate so that the Commission need not characterize as changes to by-laws matters that are more appropriately contained in an operations manual. A clearing agency, therefore, is not forced to apply to the Commission for approval each time it alters a procedure. But it

49 See section 10.03 and Commentary.

50 In May 1973 The Depository Trust Company was chartered by the New York Banking Department under the New York Banking Law as a limited purpose trust company, that is, empowered to hold securities in trust for other trustees.

may do so if for some reason it desires Commission approval of the new procedure. And the Commission may consider such procedures of its own initiative when it thinks it appropriate.

As is indicated above, the inherent complexity of any comprehensive securities transfer system makes a wooden statutory regime undesirable. Subsection (3) therefore permits the development of such systems within a relatively flexible framework subject to Commission supervision under part 10. And it gives the Commission residual power to consider and legitimate elements of the clearing systems, such as the interface between domestic and foreign clearing agencies, that cannot be anticipated before a statute is enacted.

Part 11

Market Conduct and Regulation

A registered securities exchange or association of securities firms has under part 9 a responsibility to adopt by-laws designed to ensure that its members do not engage in deceptive conduct.¹ Section 9.03, however, establishes only minimum requirements for self-regulatory organizations, and it is likely that such organizations will also retain their present by-laws concerning unethical conduct and will apply all of them to persons who seek membership and to persons who have become members.² Ethical standards are likely to be enforced by a self-regulatory organization because its members have a vested interest in ensuring that all other members maintain strict standards of honesty and fairness both to protect themselves and to maintain the confidence of investors in the integrity of the securities market.

Nevertheless, some matters are sufficiently central to the integrity of the marketplace that the Commission's regulatory jurisdiction enables it to set standards itself. Thus although self-regulatory bodies may screen applicants for membership, part 8 requires the Commission to do so as well. Under it all persons who engage in the securities business, whether or not they belong to a registered self-regulatory organization, must obtain registration from the Commission. This overlap of functions is justified by the

1 See paragraph 9.03(2)(a).

2 See section 9.09; and see e.g. Toronto Stock Exchange, By-Law 17.10(2), 3 CCH CAN. SEC. L. REP. ¶ 89-731.

importance of ensuring that persons who carry on business in the securities market meet standards established and applied by the Commission itself. In any event, as membership in a self-regulatory body is not mandatory under the Draft Act, a residual area subject to the exclusive jurisdiction of the Commission will always remain.

The same considerations apply after a person is registered. Although the self-regulatory organizations are responsible for supervising their members' conduct, there are still a number of particularly sensitive areas. (And, as mentioned above, not all registrants need belong to a body registered under part 9.) Part 11 therefore gives the Commission authority to deal with the activities of registrants that involve conflicts of interest, with specific types of trading that raise issues fundamental to the integrity of the market itself and with transactions in the over-the-counter market that come within its jurisdiction. Most of the provisions in the Part reflect regulatory experience involving the relationships between registrants and their customers and thus highlight the issues involved either by establishing a principle to govern the conduct in question or by giving the Commission power to do so by regulation. The latter device is used to enable the Commission to deal with the myriad of specific situations that can arise between registrants and their clients and to refine the standards relating to potential conflicts of interest in the light of its own regulatory experience as well as that of others. The level of detail required to deal adequately with either of these matters makes it impracticable to circumscribe them in the statute. Moreover, the solutions will benefit from the focus provided by the procedure for making regulations under part 15.³

Section 11.01

Section 11.01 codifies one element of the "know-your-client" rule that has been adopted by securities commissions and self-regulatory organizations throughout North America. The rule has two aims. It was initially adopted to require that a securities firm avoid dealing with unethical customers and others who might take unfair advantage of it.⁴ And it was subsequently extended to impose a duty on a registrant to familiarize himself with each customer's sophistication and needs so that he would not advise

3 See generally, *Connelly*, chs. IV, VI.9, 10; and cf. e.g. *In re Fischel*, [1978] OSC Bull. 8, 12 (January).

4 See e.g. *Connelly*, ch. IV.C.2; and see section 12.12, Commentary.

the customer to make trades inappropriate to his investment objectives or financial situation.

Section 11.01 adopts the latter element, the "suitability" requirement, and applies it to recommendations by registrants to their customers.⁵ The provision thus goes beyond the common law duties of honesty, good faith and reasonable care to require a securities firm to obtain information from its customers that will enable it to determine which recommendations best meet the customers' needs. In the event of a breach of that duty, a firm may be liable for damages under the provisions of part 13 and to administrative sanctions by the Commission.⁶

Subsection (2) limits the breadth of the section to make clear that it does not apply in instances where no recommendation is made in connection with a particular trade. Thus paragraph (2)(b) exempts the publication of a research report that is generally distributed and therefore does not constitute a recommendation that a specific person trade in a security discussed in it. And paragraph (2)(a) puts beyond doubt the case in which a customer places an unsolicited order with a securities firm, because an unsolicited order also does not involve a recommendation by the recipient. Paragraph (2)(a), however, only absolves a registrant from the duty to make inquiries. It has been strongly suggested that a registrant should be under an obligation to inform any person who places an order with him of material adverse information of which he is aware.⁷ As section 11.01 deals only with recommendations, it does not attempt to resolve this question. Rather it leaves it to the Commission to do so pursuant to its power to impose conditions on registration under part 8 and to its power to make regulations under section 11.02.

Section 11.02

Detailed definition in a statute of all potential conflicts of interest in relation to the activities of registrants would be completely impracticable. Sections 913 to 914 of the *ALI Federal Securities Code* contain a number of rules adopted by the Securities and Exchange Commission and also codify a number of principles developed under the Securities Exchange Act of 1934 in connec-

5 See generally, Connelly, ch. IV.E.2; and see Côté, *The Brokerage Function in the Securities Industry: Civil Liability and Investor Protection*, 10 REV. JUR. THEMIS 255, 270-73 (1975).

6 See generally e.g. Leigh, ch. I.D.

7 See e.g. Connelly at nn. 364-72; and see, *Grover & Baillie* at n. 431 and following; cf. *Nova Recreation Development Co. Ltd. v. Merrill Lynch, Royal Securities Ltd.*, 22 N.S.R. (2d) 458 (N.S.S.C. 1976).

tion with brokers and dealers. The Draft Act instead leaves all such matters for the Commission to deal with by means of regulations in the light of the experience in Canada as well as elsewhere. The power to make regulations under section 11.02 is applicable to all registrants, whether securities firms or salesmen, and provides the Commission with residual authority to supplement both common law principles applicable to registrants and the by-laws of the self-regulatory organizations. Section 11.02 thus provides the Commission with a third alternative to implementing standards by imposing conditions on registration under part 8 or requiring a registered self-regulatory body to change its by-laws under section 9.07. The advantage over ordering a change in a by-law is that the exercise of the powers under section 11.02 is direct and pervasive.

Subsection (1) authorizes the Commission to make regulations to prevent conflicts of interest and unfair treatment of customers by a registrant. The provision thus embodies the "shingle theory" developed by the Securities and Exchange Commission and U.S. courts. A person carrying on business as a registrant must act fairly toward his customers and observe obligations equivalent to those of a fiduciary. As the section applies to all registrants, both brokers and dealers are subject to it and to the principles underlying it even in circumstances where they might not be fiduciaries at common law. This result is emphasized by the fact that paragraph (1)(a) refers to any conflict between the interests of a registrant and those of his customer.⁸

The section subsumes a number of practices that might otherwise have to be prohibited outright in the Draft Act. For example, one of the "most common instances of application of the 'shingle theory'" is trading by a broker without his client's authorization.⁹ The practice is common, closely related to churning and frequently used in connection with a manipulative scheme.¹⁰ The Commission is given authority to define standards governing this type of conduct as well as other conduct to which the shingle theory has been applied, for example, the questions of when price differentials are unreasonable and when execution is unduly delayed.¹¹ And the provision is sufficiently broad to permit the Commission to proscribe manipulation by touting.¹²

8 See generally 3 L. LOSS at 1482-93; 6 L. LOSS at 3682-91; C. ISRAELS AND E. GUTTMAN, *MODERN SECURITIES TRANSFERS* 484-89 (rev. ed. 1971).

9 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 913(b)-(d), Comment.

10 See e.g. *Silverman v. CFTC*, 549 F.2d 28 (7th Cir. 1977) (unauthorized trading); *U.S. v. Grant*, 462 F.2d 28 (2d Cir. 1972), *cert. denied*, 409 U.S. 914 (1972); *In re McGroarty*, [1976] OSC Bull. 239 (September).

11 Cf. e.g. ALI FEDERAL SECURITIES CODE, ss. 913(a), (d).

12 See e.g. *id.* s. 1609; and see section 11.03 and Commentary.

One other practice, prohibited by the Criminal Code and treated in the provincial securities acts, requires mention. The Criminal Code, s. 342, prohibits short sales by brokers against customers' accounts. Several of the provincial securities acts contain the same prohibition, while others, including Ontario, create civil liability for the proscribed conduct rather than an offence.¹³ The prohibition was initially adopted in 1930 to preclude a practice that had become common in the preceding decade.¹⁴ However, the practice has apparently disappeared as a result of the capital requirements now imposed on registrants under the provincial acts and the strict surveillance maintained over them. In any event, there is strict liability for such conduct at common law in an action for conversion.¹⁵ The Draft Act therefore contains neither a prohibition of nor an express civil liability provision in relation to such conduct but leaves the matter to the Commission's regulatory powers under either subsection (1) or (2).

Subsection (2) gives the Commission similar regulatory powers over the conduct of registrants in connection with money or securities of customers held by them. Again, the powers enable the Commission to prescribe standards of conduct directly rather than impose them as conditions on registration under part 8, as is now done under the provincial acts.¹⁶

The Draft Act does not attempt to regulate the purchase of securities on margin.¹⁷ Because of the huge volume of trading in securities in the United States, a substantial increase in margin trading in a rising market may falsely accelerate a rise in securities prices and may have the added effect of increasing the money supply with the result that it also affects the national policy concerning the money supply. The Federal Reserve Board is therefore authorized to regulate margin trading under section 7 of the Securities Exchange Act of 1934.¹⁸ In Canada the stock exchanges have long imposed requirements that tend to be relatively high, possibly because of the desire of securities firms and banks to protect themselves when financing margined purchases. As no problems indicating a need for specific regulation have arisen in connection with such purchases, the Draft Act leaves the matter

13 See e.g. J. WILLIAMSON at 175 n. 164; J. WILLIAMSON, SUPP. at 212; *Connelly* at n. 230; and see Ontario Securities Act, 1978, s. 46.

14 See THE CRIMINAL CODE OF CANADA 556-57 (J.C. Martin, ed. 1955) (introduced as result of conference of the attorneys-general).

15 See *Solloway v. McLaughlin*, [1938] A.C. 247 (P.C. 1937).

16 See e.g. *Connelly*, chs. III.C.3, IV.B.

17 See section 10.07, Commentary.

18 See Regulations T and U; and see P. ANISMAN at 163-64 n. 115.

to the self-regulatory organizations, subject of course to approval by the Commission of their by-laws and to the Commission's power to require that the by-laws be changed should the need arise.¹⁹

Section 11.03

Section 11.03 provides one of the few exceptions to the approach adopted in the preceding provision by imposing on registrants who publish a recommendation concerning a specific security a duty to disclose any conflict of interest that they may have. The matter is dealt with expressly because it is central to the scheme of market regulation under the Draft Act in that it harnesses the disclosure device to deal with a potential conflict of interest in connection with an everyday practice.²⁰ The section derives primarily from the provincial securities acts which create a similar requirement for advisers and from the new Ontario act which extends it to their insiders and to dealers who publish a document "for general circulation".²¹ However the Draft Act also incorporates the policy statement adopted by the provincial commissions making the disclosure requirement applicable to all registrants.²² And as one of its purposes is to prevent scalping by any registrant, the Draft Act extends it further to include associates as well as insiders of the registrant making it.²³ Ownership of recommended securities by any such person presents an equivalent potential danger.²⁴

Section 11.03 applies to all written recommendations by a registrant and may therefore include cases in which disclosure is unnecessary because the person receiving the recommendation is aware of the conflict of interest, either because it is of a well-known type, such as a broker's commission, or because the transaction is essentially a private one. The former category may be dealt with in the disclosure requirements. The latter is presumably the kind of situation envisaged under the new Ontario act as one in which a dealer's letter is not for general circulation. Rather than carve out an overbroad exemption, the Draft Act leaves the specification of appropriate exemptions for the Commission in the exercise of its general exempting power under section 3.03.

19 See sections 9.02-9.07.

20 See also section 12.07 and Commentary.

21 See e.g. Ontario Securities Act, s. 72; Ontario Securities Act, 1978, ss. 39-40.

22 See National Policy No. 25, 2 CCH CAN. SEC. L. REP. ¶ 54-862 (December 6, 1971).

23 See section 2.04 and subsection 7.11(1) and Commentary; and see ALI FEDERAL SECURITIES CODE, s. 915(a)(1)(B).

24 See generally, Connelly, ch. IV.F.3.

Through it the Commission will be in the best position to circumscribe any exemptions appropriately.

Section 11.03 differs from the provincial source provisions in another way as well. The provincial legislation specifies the nature of the required disclosure in substantial detail, including the size of the typeface and the location of the information as well as the contents.²⁵ Section 11.03 follows the approach adopted elsewhere in the Draft Act and relegates the details of the required disclosure to the regulations.²⁶ The Commission may, therefore, prescribe the contents and manner of the disclosure of a conflict of interest under the section. Nevertheless, it is expected that it will require the information now prescribed in the provincial acts, namely, the registrant's ownership of the security recommended or of a right to acquire it, any remuneration that the registrant is likely to receive relating to its sale or pursuant to any arrangement with any person whether the issuer or an underwriter, and any other information that it considers appropriate.²⁷

Section 11.04

Section 11.04 is relatively straightforward. It authorizes the Commission to require registrants who exercise investment discretion over the accounts of customers to disclose their practices concerning the payment of commissions. This section too is intended to enable the Commission to deal with conflicts of interest, in this case those arising where a registrant both manages an account and derives commissions from trades that he executes for it as broker.²⁸ The conflict becomes most serious when there is a choice available to the registrant with regard to the commission that must be paid, either because he trades in a context of negotiated rates or because he is able to group his trades to avail himself of lower rates.

The section derives from *ALI Federal Securities Code*, s. 917(c), which is only one element of a relatively elaborate scheme to regulate the conduct of all persons who exercise investment discretion over managed accounts.²⁹ The code's provisions apply to a broad range of persons, including managers of individual and pooled trust accounts, of pension funds and of investment accounts with a securities firm. Although the source provision

25 See e.g. Ontario Securities Act, 1978, s. 39 ("conspicuous position...in type not less legible than that used in the body of the circular").

26 See generally parts 4, 5, 7.

27 And see, *Connelly*, ch. VI(11).

28 Cf. sections 12.10, 13.13 and *Commentary* (churning).

29 See *ALI FEDERAL SECURITIES CODE*, ss. 914-17.

taken alone appears to contemplate stricter standards for the administration of discretionary accounts, section 917 is intended to ameliorate the strict fiduciary standard applicable to such persons at common law and to permit them to pay more than the lowest available commission rate if it is justifiable on the basis of services received in addition to execution of trades. In short, the provision makes clear that *Rosenfeld v. Black*³⁰ does not apply to a person administering any type of a discretionary account where he can show that he reasonably believed the services received were worth the price.³¹

Although a person exercising investment discretion over another's account in Canada also has a fiduciary duty to obtain "best execution" for his customer, there has been no indication that he cannot consider a number of factors, including receipt of research and investment advisory services, in determining what constitutes "best execution". The Draft Act therefore does not expressly deal with this matter but deals only with the question of disclosure of conflicts of interest.³²

Section 11.05

Corporate and securities laws commonly prohibit a registrant who holds securities as a nominee from voting them unless he forwards the proxy materials sent to him as registered owner of the securities to the beneficial owner. A similar provision is included in the Draft Act, section 7.09. The purpose of such provisions is to ensure that the beneficial owner of the securities receives the materials so that he may have an opportunity to exercise his franchise. Section 11.05 generalizes the requirement implicit in these provisions and imposes on a registrant a duty to send all documents received concerning an issuer to the beneficial owner of the securities held by him or his nominee. The duty extends therefore not only to proxy circulars but to all other materials sent to securityholders under the Draft Act, including takeover bid circulars and annual reports. Subsection (2) imposes a complementary duty on a person sending the document, including an offeror who is not affiliated with the issuer, to supply a registrant with the number of documents requested so that he may fulfill his obligations under subsection (1). In this manner, a nominee registrant

30 445 F.2d 1337 (2d Cir. 1971).

31 See also *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1977).

32 Cf. *Re Donnelly, Clark, Chase and Haakh*, [1969-1973 Transfer Binder] CCH MUTUAL FUND GUIDE ¶ 9648 (SEC 1973) (policy of the Securities and Exchange Commission regarding mutual funds).

must act as a conduit to further the purpose of the Draft Act unless his client instructs him in writing not to do so.

The requirement parallels that in section 10.14(5) which requires a registrant to forward at his own expense to the beneficial owners of securities held in his name any material sent by the issuer where the registrant fails to supply the names when requested to a clearing agency or to the issuer. Section 10.14, however, applies only to material sent by an issuer and only when a clearing agency is involved. Section 11.05 is broader in that it applies to a registrant whether or not securities are held in a clearing agency, and applies as well to any document sent to securityholders, whether or not sent by the issuer.

In light of the extent of this duty, subsection (2) requires the sender of such materials to defray the reasonable costs of a registrant in forwarding them. The indemnification provision is made subject to subsection 10.14(5), however, as the additional costs incurred where that subsection applies result from the registrant's failure to supply the names of the owner to the issuer either directly or through a clearing agency.

Section 11.06

As most transactions between a registrant and a customer are initiated orally, by telephone, some written evidence of a transaction sent immediately upon its completion from one party to the other is likely to minimize subsequent conflicts, whether based on a misunderstanding resulting from the conversation or afterward. Section 11.06 therefore requires a registrant to send a written confirmation to his customer as soon as he completes a transaction. The section derives primarily from the provincial models. Like section 11.03, it eschews the detailed list of required contents of a confirmation in the provincial acts and relegates the required disclosure to the regulations. Again, however, it is expected that the Commission will require information like that specified in the provincial acts³³ which, among other items, expressly permit the use of codes or symbols in a confirmation slip to identify the salesman who handled the trade and the other firm that was a party to it, provided that a copy of the code and its meaning is filed with the Commission.³⁴ As the Draft Act leaves all of the contents of a confirmation slip to be prescribed, it omits as well the provisions dealing with symbols; they too may be the subject of regulations promulgated by the Commission.

33 See e.g. Ontario Securities Act, 1978, s. 35(1).

34 See e.g. *id.* ss. 35(4)-(5).

Although an investor who authorizes each trade made on his behalf may require confirmation of each, one who authorizes a registrant to purchase specific securities for him at regular and specified intervals may not. In such a case, a confirmation of each purchase serves no purpose because it does not inform the investor of information of which he was not fully aware, and periodic reports of the purchases for his portfolio may be sufficient. Indeed, the Securities and Exchange Commission recently adopted a similar provision.³⁵ Although such a provision might be adopted by the Commission under its general exempting power in section 3.03, subsection (2) expressly empowers the Commission to do so in order to focus attention on the issue.

Section 11.07

Section 11.07 complements the preceding section by imposing a duty on a registered securities exchange to keep records of trades made through its facilities and to make the information contained in them available to a person who can show that he was a party to such a trade. The purpose of the section is to enable an investor to obtain the details relating to the execution of his trade so that he may take whatever action in connection with it he thinks appropriate.³⁶ The emphasis on the time of a transaction results from the source provisions which require only the date of a transaction and the name of the exchange through which it was executed to be included in the confirmation sent to an investor and which rely on the exchange's computer facilities to collect further data such as the time of the trade.³⁷ Presumably the Commission will follow the same pattern when exercising its powers to specify the contents of a confirmation under section 11.06. It is no more difficult for an investor than for a registrant to request the information regarding the time of a transaction. And placing the onus to do so on the customer ensures that requests will be made to the exchanges only in the case of a potential conflict, that is, only on an exceptions basis.

Although the Commission has the power under section 9.12 to require an exchange to keep the records specified in this section, the provision is included expressly in the Draft Act because of its importance to an investor's ability to obtain specific information relating to the execution of his trades. Nevertheless, it is expected

35 See Rule 10b-10(b); and see, *Securities Confirmations: Delivery and Disclosure Requirements*, SEC, Securities Exchange Act Release No. 13508, May 5, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,143.

36 See generally part 13.

37 See e.g. Ontario Securities Act, 1978, s. 35(1)(e).

that the Commission will exercise its powers under section 11.07 in conjunction with those under section 9.12.

Section 11.08

The provisions in the provincial securities acts that deal with confirmations are for the most part directed at the sending of confirmations to customers and the information to be disclosed in them. One provision, however, is anomalous in that it does not require disclosure of information in a confirmation but gives the commissions power to obtain it from a registrant.³⁸ That subsection is the source of section 11.08. Although a customer may have as much interest in knowing from or through whom he purchased a security as in knowing the time or date on which he did so, the provincial legislation does not enable him to obtain it without the aid of the Commission.³⁹ As a result, the provision, while conceptually related to the confirmation requirements, is in reality an enforcement tool that enables the Commission to obtain the specified information. It is therefore included in the Draft Act as a separate section that the Commission may use not only to aid investors seeking information but also as a preliminary investigative device to determine whether there is sufficient evidence of a manipulative scheme or other improper trading to warrant the invocation of its full powers of investigation under part 14. It is included in part 11, rather than part 14, to emphasize that its purpose is to provide a means of market surveillance. Nevertheless, as the Commission may under section 11.06 require disclosure of information concerning the identity of the other party to a trade to be included in a confirmation, the most frequent use of section 11.08 may be in relation to the Commission's enforcement activities.

Section 11.09

In 1934 Parliament followed the example of the United Kingdom and included in the Dominion Companies Act a section prohibiting share hawking, that is, calls at a residence by telephone or otherwise for the purpose of selling securities.⁴⁰ The provision was subsequently incorporated in the provincial securities acts in a

38 See e.g. Ontario Securities Act, 1978, s. 35 and especially s. 35(6).

39 Compare Securities Exchange Act of 1934, Rule 10b-10(a)(3)(i) (identity of other party to trade or fact that it will be furnished on request to be included in confirmation).

40 S.C. 1934, c. 33, s. 82; see generally J. WILLIAMSON at 16-18.

variety of forms.⁴¹ While the Ontario provision prohibited all calls at residences, those of some of the provinces merely empowered the administrator to prohibit them in particular cases, presumably where the subject of the order had engaged in high-pressure selling.⁴²

When the provisions were enacted they were undoubtedly intended to protect investors from high-pressure sales by unscrupulous boiler room operators and to reinforce the efforts of largely understaffed commissions to prevent telephone campaigns to sell securities from one province to other provinces and into the United States as well. In fact, as of June 1960 there were 263 companies on the Securities and Exchange Commission's "Canadian restricted list" whose securities had been illegally distributed in the United States by means of boiler room techniques.⁴³ Since 1965, however, less concern has been expressed over this problem in the United States.⁴⁴ Indeed, as a result of the stricter standards of prospectus qualification, especially in connection with mining companies, and of the development of quasi-fiduciary principles such as the "know-your-client" rule applicable to the conduct of registrants, there is now less reason for concern about the hawking of securities.⁴⁵

Reflecting these developments, the new Ontario act removes the strict prohibition against calls at residences and adopts one like that in several of the other provinces which empowers the Commission to deny or limit a person's "right" to call at a residence in connection with a trade in securities.⁴⁶ The Draft Act follows the more recent provision and empowers the Commission to deny or restrict the right of a registrant or any other person to call at a residence for the purpose of trading in securities. The section thus enables the Commission to deal with persons whether registered or not who engage in high pressure sales tactics in connection with interprovincial trades.⁴⁷ Unlike the provincial source provisions, the section does not define residence but leaves the term for the interpretation of the Commission in any orders that it makes. The provincial acts expressly authorize the commissions to prohibit a call from within the province to a residence outside of it. Section 11.09 omits any reference to extraterritorial calls, as such calls

41 See e.g. *id.* at 176-77; J. WILLIAMSON, SUPP. at 177.

42 See Ontario Securities Act, s. 68; New Brunswick Securities Act, s. 28.

43 See 4 L. Loss at 2673.

44 See *id.*

45 See e.g. section 11.01 and Commentary.

46 See Ontario Securities Act, 1978, s. 36; compare New Brunswick Securities Act, s. 28; and see e.g. *Connelly* at nn. 324-26.

47 See section 16.01; and see e.g. *Kelley v. Carr*, 442 F. Supp. 346 (W.D. Mich. 1977) (modern boiler room operation).

come within its express words and the Commission's jurisdiction over them is clear under section 16.02.

Section 11.10

Section 11.10 authorizes the Commission to preclude the use of advertisements by a registrant whose past conduct indicates a propensity to unjustified puffery unless it first has an opportunity to review them. The section derives from the Ontario Securities Act, 1978, where it was first introduced and empowers the Commission to limit a registrant's activities without having to deprive him of his licence to carry on business. In other words, it permits the imposition of a method of surveillance as an intermediate sanction that presumably will be used by the Commission only with respect to registrants whose conduct is not sufficient to warrant cancellation of their registration. The Commission may, therefore, directly impose "continuous reporting" obligations on a registrant under this section rather than by means of a condition on his registration under part 8. As the use of advertisements in connection with a distribution is quite flexible under the Draft Act, as under the provincial laws, the section may assume some importance.⁴⁸

Once an order is made under subsection (1), the Commission may prohibit the use of or require an alteration in any particular advertisement sent to it pursuant to the order. The Commission may, however, make an order initially and exercise its subsequent powers under subsection (2) only after an opportunity for a hearing is given in accordance with section 15.17. The continuing supervisory powers of the Commission under subsection (2) enable it to prevent the use of a particular advertisement that is misleading without having to invoke its more severe powers under part 14; for example, it may make a preventative order under subsection (2) which precludes a subsequent need for a cease trading order or an application for an injunction.

The section utilizes the broad definition of "advertisement" in section 2.01. Subsection (3), however, both expands and contracts its scope. "Advertisement" in section 2.01 includes only a document "published in connection with a trade"; subsection (3) extends its meaning to include materials prepared for use in connection with a trade even before they are actually published so that the Commission may require prepublication scrutiny. The first clause of the subsection refers to material that is neither published

48 See paragraph 5.03(1)(d) and Commentary; and see e.g. Ontario Securities Act, 1978, s. 68.

nor "presented" to a purchaser. The latter term is included to ensure that private transactions which technically might not involve "publication" of material shown to the purchaser are covered.⁴⁹ Conversely, the second clause of subsection (3) excludes the various types of prospectus permissible under part 5 that otherwise would be "advertisements". As the distribution process, including the use of the specified documents, is fully dealt with in part 5, there is no need for the imposition of additional requirements under this section.

Section 11.11

Section 11.11 follows the provincial source provisions and requires any person who places an order with a broker to sell a security that he or the person for whom he is acting does not own to disclose that fact to the broker. As a "short sale" in effect requires the registrant to borrow securities to fill the order or to lend the customer his own securities, it is essential that he be informed of the fact that he is executing such a trade so that he may require the seller to deposit money or securities to cover the extension of credit involved in the sale. Moreover, as such trades constitute a form of speculation that may accelerate a market decline, the stock exchanges have adopted by-laws governing the circumstances in which they may be made.⁵⁰ Section 11.11 complements the exchanges' requirements.⁵¹

Although there are no requirements under the provincial legislation concerning the keeping of records of short sales, several provincial commissions have adopted a policy requesting registrants to retain a list of such transactions for inspection and to report failures by customers to deliver the security sold.⁵² The Commission may require registrants under the Draft Act to observe the same practices.⁵³

Section 11.12

Section 11.12 grants the Commission power to regulate both the conduct of registrants who are not members of a self-regulatory organization and trading in the over-the-counter market. Its

49 Cf. e.g. section 6.02 and Commentary.

50 See e.g. Toronto Stock Exchange, By-law 11.27, 3 CCH CAN. SEC. L. REP. ¶ 89-426 (up-tick rule); cf. Securities Exchange Act of 1934, Rules 10a-1 and 10a-2.

51 See generally D. JOHNSTON at 348-49; Connelly, ch. IV.C.6.

52 See, *Declaration as to Short Position - Listed and Unlisted Securities*, Uniform Act Policy No. 2-08, 2 CCH CAN. SEC. L. REP. ¶ 54-878 (April 1971).

53 See section 8.05.

provisions are relatively straightforward and can be discussed *seriatim*.

Although all persons who carry on a securities business are required to register under part 8, they are not required to belong to a self-regulatory organization. Thus nonmember registrants are not subject to the primary supervisory authority over their trading conduct that is delegated to registered self-regulatory bodies under part 9. The Commission may itself supervise their conduct by imposing conditions on their registration under subsection 8.02(3) to establish the duties and standards that are otherwise included in a self-regulatory organization's by-laws, or it may delegate supervision of them to an appropriate self-regulatory body under section 9.05.⁵⁴ Subsection (1) merely makes express the Commission's direct supervisory power and limits its exercise to regulations.

Subsection (1) is arguably redundant in light of the Commission's powers under subsection 8.02(3) and section 11.02. It is included to focus attention on whether membership in a registered self-regulatory organization should be made mandatory for all registrants and to make clear that if it is not, the Commission will have to assume the function of the self-regulatory organizations in relation to nonmember registrants. Indeed, there may be classes of nonmember registrants for which the present situation should be preserved. In any event, if the Draft Act is enacted, subsection (1) might be deleted and the matter left to the Commission's general powers to regulate the activities of registrants.

Similarly, subsection (2) might come within the Commission's powers to impose conditions on registration under part 8 and to require registrants to maintain and file records that it specifies.⁵⁵ Nevertheless, it is included here because of its importance to the regulatory scheme of the Draft Act. Although the Commission has no jurisdiction over intraprovincial trading that does not take place through the facilities of a stock exchange, it has authority to deal with interprovincial trading. And it has authority over the conduct of registrants. Moreover, in determining its priorities and its cooperative efforts with the provincial commissions, information about the nature and amount of over-the-counter trading may be of some importance. For example, the Commission may need to know the volume of bond trading in order to determine whether its enforcement priorities are satisfactory or whether to devise particular standards for registrants who engage in such trading. The collection of such data may thus provide useful statis-

54 See also subsection 8.05(2) and Commentary.

55 See subsection 8.05(1).

tical information and its publication may provide trading information of value to investors.⁵⁶ Indeed, similar requirements have been imposed on registrants by the Ontario commission.⁵⁷

Subsection (3) complements the preceding subsection. As no self-regulatory organization is responsible for the establishment of trading rules and the supervision of market conduct in the over-the-counter market, it may become necessary for the Commission to assume that role, at least with respect to interprovincial trading.⁵⁸ Again, although the Commission may do so indirectly by conditioning the registration of market actors under part 8, subsection (3) empowers it to do so directly should the need arise.

Section 11.13

During the early part of this decade securities having an estimated value of between \$1 billion and \$10 billion were reported to be either lost or stolen in the United States.⁵⁹ Although the Federal Bureau of Investigation had established a computerized file of reportedly stolen or missing securities, Congress in the Securities Reform Act of 1975 authorized the Securities and Exchange Commission to make rules to deal with the problem by requiring persons to file information with it and by making the filed information readily available. The Commission was also expressly authorized to cooperate with the FBI information centre for purposes of storage and dissemination of the filed information.⁶⁰ The Commission has since adopted rules to implement the new provision⁶¹ and has appointed AutEx, Inc. (Equity Trading Information System) to maintain its comprehensive data base of information on missing and stolen securities.⁶²

Although there is no public information available concerning securities stolen and missing in Canada, rumours abound about the use of stolen securities as collateral for loans obtained from Canadian banks. And the Federal Bureau of Investigation's Na-

56 Cf. British North America Act, 1867, 30 & 31 Vict., c. 3, s. 91(6) (statistics).

57 See Ontario Securities Regulations, ss. 73-76; *Condition of Registration: Over-The-Counter Trading Reports: OTC Manual for Registrants*, 2 CCH FED. SEC. L. REP. ¶ 54-935.

58 See section 16.01.

59 See e.g. SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES, SECURITIES INDUSTRY STUDY REPORT 75 (Subcomm. Print 1972).

60 See Securities Exchange Act of 1934, s. 17(f); see also ALI FEDERAL SECURITIES CODE, ss. 1009, 1903(f); and see generally, *Hebenton & Gibson*, ch. VIII.A.

61 See Securities Exchange Act of 1934, Rule 17f-1.

62 See, *Lost and Stolen Securities Program: Designation of Entity to Receive Reports and Inquiries*, Securities Exchange Act Release No. 13538, May 12, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,167.

tional Crime Information Center includes in its sytem information about securities stolen in Canada. Moreover, earlier this year it was reported that the Royal Canadian Mounted Police were initiating a computer system as part of the Canadian Police Information Centre, which would include stolen, missing and lost Canadian securities.⁶³

Section 11.13 gives the Commission power to deal with the problem similar to the power of its U.S. counterpart. The Commission may thus require registrants to file information concerning lost, stolen, missing and counterfeit securities and may require them to make inquiries concerning securities that come into their hands in order to determine whether they are among the securities that have been reported to the Commission as lost or stolen. As "registrant" includes any person registered under the Draft Act, the Commission's powers encompass not only persons registered under part 8 but also organizations registered under part 9.⁶⁴ As a result, the Commission may make its rules applicable to clearing agencies as well as to brokers and dealers and thus increase substantially their potential effectiveness.

Although information required under paragraph (1)(a) is filed with the Commission and available to the public, it may be unduly onerous to require registrants to search the Commission's files in order to comply with regulations made under paragraph (1)(b). It is probable, therefore, that the Commission will impose a duty to make inquiries only in suspicious circumstances that would lead a reasonable person to check further.⁶⁵ Even then, a requirement that a registrant examine the public file at the Commission's offices would likely involve too much delay to allow the inquiry to be effective. Subsection (2) therefore requires the Commission to make such information available upon the request of a registrant.

However, registrants are not the only persons who receive securities certificates. Financial institutions such as banks often receive certificates for their portfolios or as collateral for loans. Consequently, subsection (2) authorizes them and any other class of persons designated by the Commission, as well as registrants, to avail themselves of the Commission's duty to make available information filed with it under subsection (1). The Commission may also cooperate with the RCMP in the maintenance of a computerized system to store and disseminate information pursuant to this section.⁶⁶

63 See, *Hebenton & Gibson* at nn. 215-16 and following.

64 See section 2.35.

65 Cf. SECURITIES ACTS AMENDMENTS OF 1975: CONFERENCE REPORT, H.R. Rep. No. 229, 94th Cong., 1st Sess. 104 (1975).

66 See section 15.09 and Commentary.

Subsection (3) makes clear that a failure to make an inquiry under this section does not affect the rights of a person who holds a security. In other words, the fact that the Commission's information system is available or even that a registrant fails to fulfill his duty to make an inquiry concerning a security does not constitute constructive notice of a flaw in the security sufficient to deprive him of any rights he might otherwise have obtained as a *bona fide* purchaser for value and without notice.⁶⁷ The purpose of the subsection is to encourage financial institutions, over whom the Commission has no authority under the section, to utilize the information filed with the Commission so that the use of lost or stolen securities may be deterred.

It is probable that the problems with which this provision deals will be reduced dramatically when the type of clearing agency contemplated under part 10 is implemented on a national basis. A comprehensive securities depository, whether based on immobilization of securities certificates or on a certificateless system, will undoubtedly result in a substantial decrease in the number of lost or stolen securities.⁶⁸ Indeed this solution may be both inevitable and the most desirable.

67 See generally part 10.

68 See e.g. *Hebenton & Gibson* at n. 227.

Part 12

Fraud and Manipulation

One of the basic purposes of securities legislation is the protection of investors from fraudulent and other improper conduct in the securities market.¹ In Canada prohibitions against fraudulent conduct in connection with securities trading have been included in both the provincial securities acts and the Criminal Code.² The Draft Act includes in part 12 all of the provisions proscribing fraudulent and similar improper activities that may affect an investor's decision-making; the prohibitions derive not only from provincial and other securities legislation but also from the Criminal Code. Indeed, many of the sections in the Part are based on and intended to replace the equivalent sections in the Criminal Code. Part 12 therefore applies to all securities other than those exempted from the whole act by section 3.01.³ The reasons underlying the exemptions from the disclosure requirements are clearly not applicable to fraudulent or quasi-fraudulent conduct.⁴

The conduct prohibited in part 12 has generally been characterized as fraudulent whether consisting of false statements or of transactions that create a false impression of market activity, that is, manipulation. The concept of fraud at common

1 *See e.g.* *Lymburn v. Mayland*, [1932] A.C. 318 (P.C.); *see generally*, *Leigh*, ch. I.A; and *see* paragraph 1.02 (e) and Commentary.

2 *See e.g.* *Smith v. R.*, [1960] S.C.R. 776 (false prospectus provisions).

3 *See* section 3.01, Commentary.

4 *See* section 3.02 and Commentary.

law is also extended to include representations that may lull investors into a false sense of confidence⁵ and to include conduct that involves an inherent conflict of interest on the part of a fiduciary.⁶ In other words part 12 prohibits not only activities that technically constitute common law fraud but also representations that are likely to mislead investors by implication and conduct that is considered fraudulent in equity.⁷

The prohibitions of fraud and manipulation in part 12 serve as the basis for subsequent parts of the Draft Act that deal with the consequences of a violation. Thus part 13 prescribes the civil and part 14 the criminal consequences that may flow from a breach of the provisions of this or any other part of the Draft Act.

Section 12.01

This section prohibits the use of deception and the making of a misrepresentation and thus precludes the types of conduct now covered by the provincial securities acts and the Criminal Code provisions relating to fraud and false pretenses.⁸ The *mens rea*, that is, the intentional or other mental element, necessary for a criminal conviction is specified in part 14 as are the standards for the granting of injunctive relief on application by the Commission.⁹ This approach is possible here because different types of disclosure documents are treated separately in part 13 in order to specify the standard for and scope of liability most appropriate to each.

The breadth of section 12.01 is worth emphasizing. As has often been said, the devices that may be adopted by perpetrators of fraud cannot be catalogued; as long as greed is a human characteristic, new fraudulent techniques in connection with securities transactions will appear.¹⁰ The compound preposition, "in connection with" (rather than "in") is used to ensure that all fraudulent activities relating to investor decision-making are covered. It is clear, therefore, that investment advisory activities are

5 See section 12.05.

6 See sections 12.02-12.04, 12.10.

7 See e.g. *Gadsden v. Bennetto*, 9 D.L.R. 719 (Man. C.A. 1913); cf. *Stepps Investments Ltd. v. Security Capital Corp. Ltd.*, 73 D.L.R. (3d) 351, 363-64 (Ont. H.C. 1976) (negligent conduct "equivalent to fraud").

8 See sections 2.15, 2.24 and Commentary ("deception" and "misrepresentation"); cf. LAW REFORM COMMISSION OF CANADA, *CRIMINAL LAW: THEFT AND FRAUD* 65-73 (Working Paper 19, 1977).

9 See section 14.10; and see section 14.06, Commentary (compliance orders).

10 See e.g. *U.S. v. Brown*, 555 F.2d 336, 339-40 (2d Cir. 1977); *In re Fischel*, [1978] OSC Bull. 8, 12 (January).

included under the section as they are usually related to trading.¹¹

Similarly, deceptive activities that induce investors *not* to trade are prohibited, for investors may also suffer harm in such circumstances.¹² However, the civil consequences prescribed in part 13 are designed to ensure that persons who do not trade cannot too easily take advantage of the prohibition in order to obtain a windfall profit or to escape the consequences of a poor investment decision. They must prove the misrepresentation or deceptive acts and their connection with the decision not to trade, and it is expected that the courts will require clear and convincing evidence in such cases.

Some consideration was given to the need for paragraphs (c) and (e). The former paragraph is included to avoid an obvious gap in that some defensive tactics in connection with a takeover bid may fall within the definition of "deception" without being directed at trading by offeree shareholders. And press releases and filed documents are expressly dealt with because the standards for civil liability based on them differ from those for misrepresentations in several other kinds of documents. Paragraph (e) has a broad sweep, particularly because the definitions of deception and misrepresentation both include unintentional conduct that has a misleading effect.

Nevertheless, the effect of the provision is not inordinately broad. Criminal liability may be imposed only for knowing or reckless misrepresentation or deception,¹³ and a specific mental element is prescribed as a prerequisite for civil liability based on a misrepresentation in any of the documents covered by the section.¹⁴ Moreover, as part 13 does not expressly create civil liability for deception, the question of such liability and of the appropriate mental element is left to the courts under section 13.16.¹⁵

The *ALI Code* includes as an offence an unreasonable failure to correct a statement in one of the documents specified in this section.¹⁶ The duty created by the code would arise only when a fact that occurs after a document is sent results in its becoming misleading and there is a reasonable opportunity to correct it before the trade to which it relates is consummated. The Draft Act

11 Cf. ALI FEDERAL SECURITIES CODE, s. 1602(a)(4).

12 Cf. e.g. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1301(a), Comment (2)(a) and cases cited therein.

13 See section 14.10.

14 See generally part 13.

15 See generally, Leigh, chs. I.B.13-14; and see section 2.15, Commentary.

16 See ALI FEDERAL SECURITIES CODE, s. 1602(b).

does not contain a similar provision. Rather it imposes an obligation to correct a prospectus and requires issuers to make timely disclosure of material facts.¹⁷ And in other circumstances in which civil liability should be available for a failure to correct a particular type of document such as a takeover bid or directors' circular, it expressly provides for it.¹⁸ Other cases where a failure to correct a document that is circulated may result in damage to investors – for example, an advisory letter – are left to the Commission and the courts. If liability in such instances is justified, the definition of “deception” and section 12.01 are sufficiently flexible to permit its imposition. And if a registrant is involved, the Commission may have recourse to its regulatory powers under subsection 11.02(1).

Section 12.02

Trading by insiders in the shares of their issuer has long raised questions of propriety.¹⁹ In Canada legislation was enacted in 1966 expressly to create civil liability for insider abuses in relation to trading in securities. More recently, there has been a movement both here and in Britain to make improper insider trading an offence.²⁰ Both the British Columbia Securities Act and the Ontario Securities Act, 1978, do so and, in fact, there has been a successful prosecution under the Criminal Code for fraud in relation to insider trading, albeit in a limited way.²¹

Subsection (4) prohibits trading on the basis of inside information. As with the other provisions of this Part, the subsection merely describes the conduct prohibited, that is, trading by an insider who “knows a material confidential fact”. Any further mental element required as a basis for civil or criminal liability is specified in the sections in parts 13 and 14 that create the liability.

Section 12.02 derives from a number of diverse models and reflects an attempt to define clearly the persons subject to it and the conditions for liability. This section, in contrast to the definition of “insider” for reporting purposes,²² adopts a functional approach to the definition based on access to material undisclosed information. Thus it applies to persons who hold positions that give them access to information relating to an issuer or its securities and also to any persons who receive such information from

17 See sections 5.12, 7.03.

18 See e.g. sections 13.06, 13.08.

19 See generally, *Anisman* at 173–81, 201 n. 305.

20 See e.g. *Leigh*, ch. I.B.2.

21 See *R. v. Littler*, 13 C.C.C. (2d) 530 (Que. Sess. of Peace 1972), *affirmed*, 65 D.L.R. (3d) 443 (Que. C.A. 1974) (on merits) *varied*, 65 D.L.R. (3d) 467 (Que. C.A. 1975) (on sentence); and see, *Yontef* at n. 133.

22 See section 7.11.

them.²³ It is based directly on the Canada Business Corporations Act in expressly specifying the persons in subparagraphs (1)(b)(iii) and (iv) and indirectly on the U.S. models in adding the residual provision in subparagraph (1)(b)(v) that includes any person whose relationship to an issuer gives him access to confidential information.

Ontario Bill 30, s. 77, and the first two readings of Ontario Bill 7 included as an insider any person who knows undisclosed information.²⁴ However, the technique that it used was completely open-ended in that it simply prohibited any person with inside information from trading and, possibly as a result, the scope of the prohibition was cut back after second reading so that the new Ontario act is now limited to persons in a "special relationship".²⁵ The definition of "insider" for liability purposes in the Ontario Securities Act, 1978, is now similar to, albeit broader than, that in the Canada Corporations Act.²⁶

The Draft Act, while broader than the new Ontario act, attempts to define more precisely persons who are subject to the section. For example, the provision in Ontario Bill 30 might have been interpreted to prohibit a person who decides to make a takeover bid from purchasing securities in the offeree corporation before announcing the bid and the Ontario Securities Act, 1978, is susceptible to the same interpretation.²⁷ The Draft Act clearly excludes offerors from the definition of insider so that they may warehouse, but it includes any person whom an offeror informs of an intention to make a bid, so that third parties may not use advance information about a bid for their own benefit.²⁸

Subsection (3) applies to "persons" in order to include all offerors whether or not natural persons, and subsection (2) creates a similar presumption for issuers that propose to enter into a business combination. The Draft Act thus attempts to be both comprehensive and sufficiently precise to ensure that persons may make use of information that they develop themselves. Thus under subsection (3) insiders of a takeover bidder become insiders of a proposed offeree issuer when the offeror proposes to make a bid and cease to be so when the proposal is dropped. As a result, any trading by them in the securities of either issuer during the period after the offeror decides to make a bid and before he announces it

23 See e.g. *Yontef* at n. 208.

24 See e.g. Ontario Bill 7 (2d reading), s. 75.

25 See Ontario Securities Act, 1978, s. 75.

26 See e.g. *Anisman* at 207-08.

27 See Ontario Securities Act, 1978, s. 75 (3)(c) ("company ...proposes to engage in any business ...with ...the reporting issuer and thereby has acquired knowledge" of a material change in its affairs).

28 See subsection (3); cf. *Anisman* at 268-70.

publicly or decides not to proceed with it, but only during that period, makes them subject to subsection (4). And the same is true of insiders under subsection (2). However, once merger negotiations have been initiated a proposed merger partner is an insider of the other issuer by virtue of subparagraph (1)(b)(v), and an offeror in a negotiated takeover bid would be in the same position. This approach is possible here, although not in connection with insider reporting, because liability for improper trading is based on knowledge of confidential information.

A takeover bid provides only one example of "market information". Information that is likely to affect the value of an issuer's securities even though it derives from a person other than the issuer has in a number of instances been treated as inside information.²⁹ Although the insider liability provisions in the present Canadian securities and corporate legislation include such information, it appears that the prohibition in the new Ontario act may have excluded it.³⁰ However, the act's liability provision probably will be interpreted to apply to such information.³¹ As Professor Loss stated, "there is no reason in...principle...to distinguish...between material information that is intrinsic to the company... and market information that will not affect the company's assets or earning power"³² and the Draft Act does not do so. In fact, it expressly includes market information.³³

An insider is prohibited from trading only if he knows information that is both confidential and material. Confidentiality is based upon whether the information is public,³⁴ and materiality is defined in terms of the likely influence of the fact on a reasonable investor's decision whether to trade.³⁵ The present insider liability provisions are framed in terms of information that is likely to have a significant effect on the market price of a security. Professor Loss suggests that this formulation imposes a stricter standard³⁶ and adopts it in the *ALI Code* in the definition of a "fact of special significance" which applies only to insider trading.³⁷

Subsection 12.02(4) retains the general materiality standard. In the context of insider trading there is no significant difference

29 See generally e.g. Fleischer, Mundheim and Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973).

30 See Ontario Securities Act, 1978, s. 75; *Anisman* at 217 n. 405, 226-27.

31 See Ontario Securities Act, 1978 s. 131.

32 ALI FEDERAL SECURITIES CODE, s. 1603, Revised Comment (2)(j).

33 See subsection (4) ("fact with respect to an issuer or a security of the issuer").

34 See subsection (5); and see section 2.31 ("public" information).

35 See section 2.22.

36 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 256 (a), Comment (1).

37 See ALI FEDERAL SECURITIES CODE, s. 257.

between the definition of materiality in section 2.22 and that in the statutes referred to above.³⁸ Moreover it is difficult to envisage a concrete situation that would turn on the difference between a fact "to which a reasonable person would attach importance" (s. 2.22(1)) and one which he would "consider...especially important".³⁹

The new Ontario act permits a defence to an insider who proves that he did not "make use of" material confidential information known to him at the time that he traded.⁴⁰ The defence incorporates an element that results from judicial interpretation of the present Ontario Securities Act, s. 113, and that may not unreasonably be said to have led to an incorrect result in every case in which it has been considered.⁴¹ As a result the advisers concluded that a similar defence should not be included and accordingly the Draft Act bases the prohibition in subsection (4) solely on knowledge of a material confidential fact.

As section 12.02 rests exclusively on knowledge of confidential information, it is necessary to consider the problems created when some officers of an organization possess confidential information as a result of a position held or business dealings conducted with an issuer. Some concern has been expressed over the possibility that the knowledge acquired by a partner of a securities firm as a result of a directorship on an issuer's board or as a result of a proposed underwriting might be attributed to the firm and make it liable for trading in the issuer's securities even though the "organization's" decision to trade was not influenced by the inside information known only to the actual insider.⁴² Because of this concern, a provision containing a "Chinese wall" defence was presented to and discussed by the advisers.⁴³ Although it was determined not to include the provision in the Draft Act itself, it is set out below in order to provide a focus for discussion of the issues.

An insider, other than a natural person, referred to in sub-

38 See, *Anisman* at 228-29, 231-34.

39 ALI FEDERAL SECURITIES CODE, s. 257(b).

40 See Ontario Securities Act, 1978, ss. 75(2), 131(1)(c), 131(2)(c); see generally, *Yontef*, ch. III.C.5.

41 See *Green v. Charterhouse Group Canada Ltd.*, 12 O.R. (2d) 280, 306-08 (C.A. 1976); *In re Connor*, [1976] OSC Bull. 149, 169 (June); cf. *Waldron v. Green*, CCH AUST. SEC. L. REP. ¶75-020 (Vict. S.C. 1978); and see e.g. *Buckley, How to Do Things with Inside Information*, 2 CAN. BUS. L.J. 343 (1978); but see *Baillie & Alboini, The National Sea Decision - Exploring the Parameters of Administrative Discretion*, 2 CAN. BUS. L.J. 454, 467-68 (1978).

42 See e.g. *Dey, Securities Reform in Ontario: The Securities Act, 1975*, 1 CAN. BUS. L.J. 20, 44-45 (1975); but see *Anisman* at 219 n. 414.

43 On the "Chinese wall" generally, see, *Yontef*, ch. III.C.5; *Connelly*, ch. IV.F.1.

paragraph (1)(b)(v) or (vi) does not violate subsection (4), if
 (a) it knows a material confidential fact by reason only of the fact being known to one of its directors, partners or employees who is otherwise an insider of the issuer,

(b) the decision to trade in a security of the issuer is not made by the director, partner or employee referred to in paragraph (a),

(c) arrangements satisfying standards prescribed by the Commission exist to ensure that the fact is not communicated and that no advice with respect to securities of the issuer is given by the director, partner or employee referred to in paragraph (a) to any other person connected with the insider, and

(d) the fact is not so communicated and advice is not so given.

The draft provision assumes that the firm or other similar organization is an insider by virtue of its director's or employee's knowledge and provides that it does not violate subsection (4) if it fulfills the specified conditions which are intended to ensure that no trading or other activities by the firm relating to securities of the issuer in question are affected by the confidential information. The provision thus would legitimize use of the so-called "Chinese wall" but in a manner that would protect a firm from liability only if the "wall" exists and is not breached. Moreover, the firm has the burden of proving that it comes within the exception.

The provision is based upon the similar subsection in the United Kingdom Companies Bill introduced in December 1973⁴⁴ and adopted recently in Australia,⁴⁵ and it also authorizes the Commission to make regulations establishing standards for the protective arrangements. Paragraph (c), however, is drafted so that the arrangements must comply with the regulations only if they are enacted. Even if no regulations are promulgated by the Commission a "Chinese wall" may still fall within paragraph (c). Moreover, a corporation that is itself a direct insider of an issuer by virtue of its shareholdings (within subparagraph (1)(b)(iv)) could not avail itself of the provision; such a corporation has a direct interest in knowing of the issuer's activities in order to protect its investment and is not in the position of, for example, a securities firm that places a partner on an issuer's board as an accommodation.

One final matter requires mention. The provision in the *ALI Code* does not prohibit tipping but instead leaves it to be dealt with

44 Bill 52, s. 14(3) (1973).

45 See New South Wales, Securities Industry Act, 1975, s. 112(7).

in relation to civil liability.⁴⁶ Subsection (4), however, follows the approach adopted in the Ontario Securities Act, 1978, and prohibits its tipping as well as trading by insiders.⁴⁷

As it may be necessary for an insider to disclose material confidential information for the business purposes of the issuer, for example, when negotiating a merger or sale of corporate assets, a defence available to informants is established by paragraph (4)(b). An insider who discloses nonpublic information for a proper business purpose is not in breach of the prohibition in subsection (4) if he reasonably believes that the person whom he informs will not use the information to trade in violation of the subsection. The qualification based on reasonable belief derives from the United Kingdom Bill, s. 12(4)(b), and is included to prevent an insider from informing another person, even if a legitimate business purpose to do so exists, where he has reasonable grounds to believe that his tippee will use the information to trade.⁴⁸

Section 12.03

Speculation by insiders in securities of their issuer has long been considered improper in Canada. The prohibition of short selling by insiders (subsection (1)) was taken from the Securities Exchange Act of 1934 and included in the Canada Corporations Act in 1970. The *Proposals for a New Business Corporations Law for Canada* affirmed the policy, concluding that there "is nothing to be said in favour of allowing an insider to 'sell short' the shares of a corporation in which he is an insider", and the provision was included in the Canada Business Corporations Act in a somewhat modified form.⁴⁹

The Draft Act omits the prohibition in the latter statute against an insider selling margined securities because it is too easily avoided and thus is likely to be little more than a "trap for the unwary". However, it does preclude sales of securities by an insider where borrowed securities, rather than those held, are delivered to complete the sale ("sales against the box"). Such transactions are also prohibited by the Canada Corporations Act and the U.S. Securities Exchange Act of 1934 to prevent conduct by an insider equivalent to short selling, and there are some indications that the practice may occur in Canada in connection

46 See ALI FEDERAL SECURITIES CODE, s. 1603, Revised Comment (5) and s. 1724(c).

47 See Ontario Securities Act, 1978, s. 75(1)(b).

48 Cf. *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275 (2d Cir. 1975) (disclosure relating to private placement).

49 See generally, *Yontef*, ch. III.B.

with manipulative activities.⁵⁰ Paragraph (1)(b) reflects the definition of "short sale" in the *Mutual Fund Proposals*.⁵¹

The phrase "right to acquire a security"⁵² in paragraph (1)(a) incorporates the exceptions in the Canada Corporations Act, s. 100.6(3), and the Canada Business Corporations Act, s. 124(3). Paragraph (b) also continues the policy of the source provisions that an insider who has such a right must deliver it or exercise it and deliver the underlying security to complete the sale.

The application of subsection (1) is limited to the insiders specified in subparagraphs 12.02(1)(b)(i) to (iv) in order to avoid a prohibition against short selling by persons who are insiders by reason only of a relationship with an issuer that may give them access to confidential information.⁵³ The section therefore does not prohibit short sales by a person merely because he is retained by an issuer. However, if any such person trades when in possession of confidential information, he is subject to the prohibition in section 12.02.

Subsection (1) also gives the Commission the power to exempt specified transactions by regulation so that transactions for which the prohibition is inappropriate may be excepted.⁵⁴ It is likely that exemptions similar to those under the Securities Exchange Act of 1934 will be adopted as well.⁵⁵

Subsection (2) also derives from the antipathy to speculation by directors and officers. A similar prohibition was initially taken from the United Kingdom Companies Act, 1967,⁵⁶ included in the Canada Corporations Act in 1970 and carried over to the Canada Business Corporations Act. As actual misuse of confidential information is already prohibited in section 12.02, there is little reason to include all insiders within the prohibition against trading in puts and calls. Consequently only the issuer, its affiliates, employees and directors are prohibited from such trading, primarily because transactions in puts and calls can create an inherent conflict of interest with their duty to the corporation.⁵⁷ It is likely for this reason that the *Jenkins Report* concluded that no "reputable director would deal in such options in any circumstances".⁵⁸ In light of the development of exchange trading markets in puts and

50 See M. FLEMMING, UNDER PROTECTIVE SURVEILLANCE 67, 81-82 (1976).

51 See 2 MUTUAL FUND PROPOSALS, s. 1.01(1).

52 See section 2.39.

53 See subparagraph 12.02(1)(b)(v).

54 See e.g. Fuller v. Dilbert, 244 F. Supp. 196 (S.D.N.Y. 1965), affirmed per curiam sub nom. Righter v. Dilbert, 358 F.2d 305 (2d Cir. 1966).

55 See Rules 16c-1-16c-3.

56 15 & 16 Eliz. II, c. 81, s. 25.

57 See, Anisman at 206 n. 336.

58 REPORT OF THE COMPANY LAW COMMITTEE, Cmnd. 1749, ¶ 90 (1962).

calls in Canada, the prohibition has been extended beyond purchases, as in the present legislation, to all trading so that the writing of put and call options is also precluded.

Section 12.03 applies only to insiders of reporting issuers because such practices are possible or likely only where a public market exists. If there is actual misuse of inside information in relation to an issuer that has distributed its securities to the public but has not become registered under part 4, section 12.02 applies.⁵⁹

Section 12.04

Section 12.04 prohibits representations that are likely to lull an investor into a false sense of confidence or are intended to assure him that he will not risk anything by trading in a particular security. Subsection (1) accomplishes the former purpose by proscribing representations that indicate that the Commission in any way certifies the merits of a person or an investment through its registration process. Similar provisions are contained in virtually all securities legislation. The Ontario acts prohibit as well representations that a person is registered as a broker or dealer, whether or not he is.⁶⁰ The Draft Act, like the *ALI Code*, does not prohibit a true statement of the Commission's action so long as no representation that violates subsection (1) is made with it. As a result no express exemption of such a statement is required.⁶¹

Subsection (2) prohibits representations which are most likely to be made in connection with a distribution but are sufficiently basic that their prohibition should not be confined to either registrants or distributions.⁶² Paragraph (2)(a) derives from the *ALI Code*, s. 1609(e), and paragraph (2)(b) from the provincial models. A security that "is accompanied by" an obligation of the issuer to redeem or repurchase it is expressly included in the latter paragraph to make clear that retractable preference shares, that is, shares that are accompanied by a separate contract imposing an obligation on the issuer to repurchase at the purchaser's option, are permitted.

Although paragraph (2)(b), if read alone, is broad enough to include a buy-sell agreement between securityholders of an issuer, it is not intended to do so. Rather the provision is directed at

59 See paragraph 3.01(e) and Commentary.

60 See Ontario Securities Act, ss. 75-76; Ontario Securities Act, 1978, ss. 43-44.

61 But cf. ALI FEDERAL SECURITIES CODE, s. 1605 (b).

62 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1308(e), Comment (1); and cf. *Nelson v. Hench*, 428 F. Supp. 411 (D. Minn. 1977) (broker, while insolvent, represented that he would reimburse client for losses); see also, *Connelly*, n. 292.

securities that are sold in the market or to public investors. Private agreements of the type mentioned are usually made between securityholders of closely held corporations which are exempted from the whole of the Draft Act by paragraph 3.01(e). And those that are not will probably be made within a single province and thus will not be subject to the Draft Act in any event.⁶³

Subsection (3) derives from the provincial securities acts and, like the source provisions, applies not only to a registrant but also to any person who gives an undertaking of the type described.⁶⁴ The Ontario legislation exempts from the application of the equivalent of paragraph (2)(b) and subsection (3) a representation "made to a person or company...[that is] contained in an enforceable written agreement" if the security involved "has an aggregate acquisition cost of more than \$50,000".⁶⁵ The exemption is not included in the Draft Act; instead the Commission is given rule-making power to create exemptions so that it may exempt all transactions for which the protection of subsection (2) or (3) is not required. It is expected that the Commission would give immediate consideration to the adoption of an exempting regulation similar to the provision in the Ontario legislation.

Section 12.05

Section 12.05 prohibits the touting of securities. It is taken from the *ALI Code* which contains an expanded version of subsection 17(b) of the Securities Act of 1933. Although the latter provision "has not had a broad application", Professor Loss concluded that it "is worth preserving".⁶⁶ The activities described in the section would usually require registration as an adviser under part 8 of the Draft Act, but the registration requirement does not deal with them directly. And although there may be some overlap with the requirements of section 11.03, the prohibition here is substantially broader in that it is limited neither to registrants nor to written recommendations. Moreover, its inclusion in part 12 indicates the potential effect of the proscribed conduct on the confidence of investors and the seriousness of the offence. In fact, the conduct covered by the section is also prohibited under the Criminal Code, s. 338(2).⁶⁷

63 See section 16.01 and Commentary.

64 See e.g. Ontario Securities Act, 1978, s. 37.

65 *Id.* s. 37 (4).

66 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1307, Comment (1); see also 3 L. Loss at 1518-19.

67 See *R. v. Violi*, (Que. C.A. February 7, 1977, unreported) (payment of money to tout);

Section 12.06

This section prohibits the activities commonly known as "wash trading"; it tends to follow the wording of the Criminal Code which was based on the Securities Exchange Act of 1934, s. 9(a)(1).

One major alteration has been made in the substance of the prohibition. In the 1960s several decisions interpreted the source section in the Criminal Code to require proof beyond a reasonable doubt of an "intent to create a false or misleading appearance of active public trading".⁶⁸ These decisions caused much concern about the effectiveness of the Criminal Code as a means of dealing with wash trading, and draft amendments that met the approval of the provincial administrators and the self-regulatory bodies were prepared as a result of a federal-provincial administrators' conference.⁶⁹ A later decision of the Ontario Court of Appeal indicated a better understanding of the purpose of the prohibition against wash trading,⁷⁰ and the excesses of the interpretation in the *Jay* case were negated by a subsequent decision of the same court.⁷¹ Nevertheless *Regina v. Jay* has not been expressly overruled and the recently proposed amendment to the wash trading section of the Criminal Code which would create a reverse onus probably would not have altered the result in the case.⁷²

Section 12.06, therefore, does not require an intent to create a false or misleading appearance of active trading. Rather, it prohibits the specified conduct where it is reasonable to expect that it will have such an effect. By imposing an objective standard based upon the effect of the prohibited conduct, it removes any possible need to prove a specific intent to manipulate the market. As well, it adopts the approach, reflected elsewhere in part 12, of describing prohibited conduct in objective terms. Any required intent is specified in the provisions relating to civil and criminal liability in parts 13 and 14. The section thus meets the objections based upon the interpretation in *Jay*, without requiring a reversal of the onus of proof normally placed upon the Crown in criminal prosecutions.

cf. *R. v. Lynch*, 40 C.C.C. (2d) 7 (Ont. C.A. 1978) (insufficient evidence to prove bribe to induce trade in violation of Criminal Code, s. 338(1)).

68 *R. v. Jay*, [1965] 2 O.R. 471, [1966] 1 C.C.C. 70 (Ont. C.A.). The decisions are discussed in J. WILLIAMSON, SUPP. at 193-96.

69 See, *Leigh* at nn. 11-13.

70 See *R. v. MacMillan*, 66 D.L.R. (2d) 680 (Ont. C.A. 1969).

71 See *R. v. Lampard*, [1968] 2 O.R. 470 (C.A.), *reversed on other grounds*, [1969] 3 C.C.C. 249 (S.C.C.).

72 See Criminal Law Amendment Act, 1978, Bill C-51, 30th Parl., 3d Sess., s. 46 (First reading May 1, 1978) (adding new section 340.1).

One further matter merits comment. The decision in *Jay* included a statement which was interpreted to require that matching orders be of the same size, in other words, that it is necessary to prove that the individual orders in question match on a one-for-one basis, in order to come within the prohibition in the Criminal Code.⁷³ The Court's statement did not clearly so require; it can as easily be read as a restatement of the wash trading provision in the Court's words. The phraseology of the Code relating to orders has therefore not been altered, for it is clear that the singular includes the plural.⁷⁴ Thus an order to purchase 1,000 shares that is matched against two *orders* to sell 500 shares would come within the prohibition in paragraph 12.06(b).

Section 12.07

Section 12.07 follows the provision in the *ALI Code* which in turn is based on the Securities Exchange Act of 1934, s. 9(a)(2). The substance of the prohibition is included in the Criminal Code of Canada, s. 338(2). When the wash trading section was adopted in 1948, the provision of the Securities Exchange Act of 1934 relating to manipulation by trading was not. It is reasonable to infer that the latter section was omitted because the conduct was already covered by the predecessor of subsection 338(2).⁷⁵ The only reported case under the subsection is *McNaughton v. The Queen*,⁷⁶ which upheld a conviction for conspiracy to manipulate the market in the securities of Pan American Mines Ltd. by creating a misleading appearance of active trading and raising the price of securities.⁷⁷

Section 12.07, in contrast to the approach taken with regard to wash trading, does require proof of intent to establish a violation.⁷⁸ While an objective approach is appropriate to wash trading because the conduct that constitutes the offence, if it has any effect at all, necessarily creates a misleading appearance of trading, the same is not true of the activities described in this section. It is possible, in fact likely, that persons often trade in securities for a legitimate purpose in circumstances where it is reasonable to

73 See J. WILLIAMSON, SUPP. at 193-94.

74 See Interpretation Act, s. 26(7).

75 For the history of the provision, see THE CRIMINAL CODE OF CANADA 552-54 (J.C. Martin, ed. 1955) (s. 323, annotation); and see generally J. WILLIAMSON, SUPP. at 192. 33 C.R.N.S. 279 (Que. C.A. 1976).

76 See also R. v. Kirsch (Que. C.A. February 7, 1977, unreported); R. v. Violi (Que. C.A. February 7, 1977, unreported); and cf. *In re Hodal*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, May 6, 1977, at 3 (Corporate and Financial Services Commission April 28, 1977).

78 See section 12.06 and Commentary.

believe that their trades will induce others to trade. Therefore it is necessary to include an intent element in the prohibition of manipulation by trading.⁷⁹

The determination of whether intent has been proved will, of course, always depend on the facts of an individual case. However, "proof of a *motive* to manipulate, when joined with the requisite" number of trades, should be sufficient to establish *prima facie* "the manipulative *purpose* and shift...to the accused the burden of going forward with the evidence".⁸⁰ There is also a substantial body of jurisprudence, both judicial and administrative, under the source provision in the Securities Exchange Act of 1934 that can provide Canadian courts with further guidance in the interpretation of the section.⁸¹

The section does not include stabilizing purchases by underwriters in connection with a distribution. While purchases to facilitate a distribution are necessary to counteract the depressing effect on the market price of the distribution itself, they also create risks of improper manipulative conduct. Indeed the *ALI Code* contains a provision specifically directed at "buying during a distribution".⁸² The section codifies the basic principles of Rules 10b-2 and 10b-6 under the Securities Exchange Act of 1934 which prohibit a person involved in a distribution from manipulating the market price of the securities being offered in order to induce investors to purchase in the distribution.⁸³ As the provision is relatively complex and would necessitate exempting regulations in any event, the Draft Act does not attempt to duplicate or adapt it, especially as there is no experience with similar rules in Canada. Instead it leaves the matter to the Commission to develop appropriate regulations and makes the prohibition in section 12.07 subject to any such regulations that are adopted pursuant to section 12.11. The Commission may also consider adopting regulations to define what is permissible stabilization in connection with a distribution. Nevertheless, as stated above, even without such regulations the section does not cover stabilization.⁸⁴ This position

79 Cf. LAW REFORM COMMISSION OF CANADA, CRIMINAL LAW: THEFT AND FRAUD 36 (Working Paper 19, 1977) (section 5.5, example (3)).

80 3 L. LOSS at 1552-53. See e.g. *McNaughton v. The Queen*, *supra* note 76 (market-maker bought 482,058 shares and sold 287,450 through dummy corporations and price of shares rose from \$1.50 to \$12 in five-month period, at 287; motive of market-maker \$71,000 in commissions and possible bribes, at 288, 295; motive of accused desire to please one of promoters, at 293, 296).

81 See generally 3 L. LOSS at 1549-60; 6 *id.* at 3757-59.

82 ALI FEDERAL SECURITIES CODE, s. 1609(d).

83 See e.g. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1308 (d), Comments (1), (2); see also 3 L. LOSS at 1595-1604; 6 *id.* at 3765-77 (discussing Rule 10b-6).

84 See e.g. *Leigh* at n. 8; *Hebenton & Gibson*, n. 232; cf. *McNaughton v. The Queen*, *supra*

is implicit in the fact that stabilizing purchases in connection with a distribution is designed to maintain the price or retard a decline caused by the distribution itself rather than to "raise the price of the security", the effect required to constitute an offence under paragraph (a).

Section 12.08

Section 12.08 prohibits short tendering pursuant to any takeover bid, including a bid by an issuer to purchase its own shares. Short tendering is used primarily by brokers and dealers who in a partial bid tender more shares than they own. As a result, in the prorationing after the bid's completion a disproportionate number of their shares are purchased by the offeror to the detriment of other tendering offerees. As an ability to estimate the number of shares that are likely to be tendered and so to predict the basis of the prorationing is necessary for effective short tendering, any nonprofessional who desires to engage in the practice would have to be very sophisticated and close to the market. But whoever tenders short obtains an advantage at the expense of other tendering offerees.

Short tendering is prohibited in the United States, and a similar prohibition was recommended in Canada as early as 1972.⁸⁵ In fact the practice is not unknown in Canada. Short tendering occurred in 1974 in the takeover bid for the Price Co. by Abitibi Pulp and Paper Company Limited and has been the subject of administrative proceedings by the Quebec Securities Commission.⁸⁶ Criminal charges based on the same conduct have been remitted for trial after a preliminary hearing.⁸⁷

As the section requires a person who tenders to own or have a right to acquire the tendered securities or to reasonably believe that the person on whose behalf he tenders does so, it accomplishes

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- note 76, at 281-82 (*per* Montgomery, J.A.), 285, 287 (*per* Turgeon, J.A.); and *cf. e.g.* Klein, *Stabilizing Securities Prices*, 5 SEC. REG. L.J. 13, 14-16 (1977).
- 85 See Anisman, *Takeover Bid Legislation in Canada: The Definitions, Exemptions and Substantive Requirements*, 11 WEST. ONT. L. REV. 1, 95-96 (1972).
- 86 See *Re Francesco A. Constantini*, Decision 5096, 7 QSC Weekly Bulletin, October 26, 1976 (revoking registration of trader who aided and abetted short tendering), *modified*, 8 QSC Weekly Bulletin, September 27, 1977 (Que. Prov. Ct. September 22, 1977) (sanction "too severe"); see also *Re Francesco A. Constantini*, Decision 5361, 8 QSC Weekly Bulletin, September 27, 1977 (reinstating registration).
- 87 See *R. v. Constantini*, 8 QSC Weekly Bulletin, August 2, 1977 (Que. Sess. of Peace, July 21, 1977) *certiorari denied sub nom. Constantini v. Bilodeau*, 8 QSC Weekly Bulletin, October 18, 1977 (Que. Sup. Ct., October 7, 1977).

a number of the aims recently proposed by the Securities and Exchange Commission.⁸⁸

Section 12.09

This section is a substantially simplified version of the prohibition against bucketing in the Criminal Code, that is, against entering an order to buy or sell a security exclusively for speculative purposes and without any intention of delivering the security to complete the trade. The Draft Act retains the requirement that a person intends to profit from fluctuations in the price of the security that he agrees to trade, in order to make clear that an element of gambling is involved in the offence. However, it omits the reverse onus in Criminal Code s. 341(2). Proof that a person who agreed to trade in a security failed to deliver the security to the registrant with or through whom the trade was executed should be sufficient to shift to him the burden of adducing evidence to rebut the inference that he intended to profit from his failure to deliver and that he had the intent required under paragraphs (a) and (b).⁸⁹ Indeed it is arguable that the conduct prohibited involves fictitious transactions that are themselves improper whether the person trading intends to profit from a change in price or in some other manner.

There are no recently reported decisions under the Criminal Code s. 341, but it is not clear whether the lack of cases exists because bucketing operations are no longer carried on in Canada or for some other reason. In recent years, however, there has been an increase in the number of fictitious orders placed with brokers in the United States.⁹⁰ Although the source provision was originally intended to prevent professionals from gambling against their clients, both it and section 12.09 are sufficiently broad to cover similar conduct by customers at the expense of registrants and would, therefore, prohibit the conduct described above.

88 See, *Short Tendering Rule: Notice of Proposed Amendment of Rule 10b-4*, Securities Exchange Act Release No. 14157, November 1, 1977, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,363.

89 Cf. section 12.07, Commentary.

90 See e.g. New York Stock Exchange, Information Memo No. 76-7, March 1, 1976; Information Memo No. 77-19, April 15, 1977; Information Memo No. 77-31, June 29, 1977 (all dealing with fictitious orders placed with exchange members); see also e.g. Kaufman, *Caught Short: The Hornung Brothers Aren't Being Cheered In Wall Street Arena*, The Wall Street Journal, August 19, 1977, at 1, col. 1 (practice of placing orders to sell unowned securities and purchasing to fill order only if price falls; otherwise "would walk away from the transaction"); *Investor Defrauded 11 Securities Firms, Says SEC Complaint*, The Wall Street Journal, November 10, 1977, at 10, col. 3 (similar conduct basis of SEC injunctive proceeding); and see, Connelly, ch. IV.C.2, summarizing *In re W.D. Latimer Co. Ltd.*, [1975] OSC Bull. 103 (March).

Neither the source provision nor the Draft Act prohibits trading in futures or options.⁹¹ In addition, the provision in the Criminal Code expressly excludes cases where a broker receives delivery on behalf of a customer and retains or pledges the delivered security for a margined account. This exception has been omitted from the Draft Act because it is superfluous. Where a broker retains a security for a customer's account, sufficient delivery to complete the trade has been made and a subsequent pledge by the broker is irrelevant.

Section 12.10

Section 12.10 prohibits churning of a customer's account by a broker or dealer and churning by any person of an account over which he exercises investment discretion. The definition of the activity prohibited is taken from the *ALI Code* which embodies rule 15c1-7(a) under the Securities Exchange Act of 1934 and a functional definition of churning derived from judicial decisions.⁹² Although churning is frequently accompanied by a breach of the suitability requirements, the two need not go together; in fact whereas the latter involves a failure to take into account a customer's needs in light of his financial position, churning usually consists of a pattern of trading designed to increase a registrant's commissions or profits and has generally been treated as a form of fraud.⁹³ Such conduct may also be characterized as a conflict of interest of a fiduciary, that is, as equitable fraud, within part 11.

The factors in subsection (3) are intended to indicate when such an improper purpose exists.⁹⁴ Although an intention to derive profit or commissions from trading regardless of the interests of the customer is essential to churning, the source provisions leave that element to be inferred as a matter of fact and the courts have acted accordingly.⁹⁵ Nevertheless, the amount of profit or commission derived in relation to the size of the customer's account is given primacy in subsection (3) in order to emphasize this element.⁹⁶

91 See, *Honsberger*, ch. IV.C; D. JOHNSTON at 383-84 (discussion of the cases dealing with this question in connection with commodities).

92 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1306, Comment (1); and see generally, *Connelly* at nn. 398-403.

93 See e.g. *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970); cf. section 11.01 and Commentary.

94 See e.g. *Smith v. Siegel Trading Co.*, CCH COMMODITY FUTURES L. REP. ¶ 20,434 at 21, 764-65 (CFTC 1977).

95 See e.g. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968), affirmed, 430 F.2d 1202, 1209-10 (9th Cir. 1970).

96 Cf. ALI FEDERAL SECURITIES CODE, s. 1606, Note (2).

It is clear that the list of factors in subsection (3) is not exhaustive.⁹⁷ Thus trades effected on the instructions of a customer may not be "excessive" even though they would be if based on the registrant's recommendations.⁹⁸

The source provision applies only to registrants, as does subsection (1). Subsection (2), however, applies to any person who exercises discretionary authority over an investment account and expressly includes trust companies and other trustees as well as registrants. Because churning involves a breach of a fiduciary obligation and smacks of fraud it should be prohibited generally, regardless of the institutional character of the person engaging in it and regardless of the coverage of other parts of the Draft Act.

Section 12.11

The Draft Act makes no attempt to define and proscribe manipulative conduct in connection with a distribution.⁹⁹ Instead, as under the Securities Exchange Act of 1934, it authorizes the Commission to deal with such conduct in the light of the needs of the Canadian market. The power to do so is granted to it by paragraph 12.11(a).

This approach is possible because section 12.07 is framed so that it does not apply to stabilization activities undertaken to facilitate a distribution.¹⁰⁰ Nevertheless, the definition of manipulation during a distribution is inextricably related to the definition of "stabilization".¹⁰¹ In fact, although the Securities and Exchange Commission has had authority to enact rules prohibiting stabilization since 1934, it has exercised the power only in relation to distributions.¹⁰²

Stabilization has, however, been used other than in relation to distributions, for example, "to maintain the collateral value of a security...the prestige of the distributors or the goodwill of purchasers after the completion of a distribution...[and] also in order

97 Cf. e.g. *Van Alen v. Dominick & Dominick, Inc.*, 560 F.2d 547 (2d Cir. 1977) (defendant a chartist who traded wife's account in same manner as plaintiff's); CFTC, *Proposed Standards of Conduct for Commodity Trading Professionals for the Protection of Customers*, September 6, 1977, CCH COMMODITY FUTURES L. REP., ¶ 20,474 at 21,930-32.

98 See e.g. Municipal Securities Rulemaking Board, *Notice of Filing of Fair Practice Rules*, September 20, 1977, CCH MSRB MANUAL, ¶ 10,030 at 10,375.

99 See section 12.07, Commentary.

100 Cf. ALI FEDERAL SECURITIES CODE, s. 1610(b)(1)-(3) (conditions for permissible purchases to retard depressant effect on market of distribution itself).

101 See 3 L. LOSS at 1596.

102 See Rule 10b-7; and see 3 L. LOSS at 1583-94; ALI FEDERAL SECURITIES CODE, s. 1610(b).

to preserve public confidence in the soundness of a bank".¹⁰³ And the Securities and Exchange Commission at one time proposed the prohibition of all stabilization but subsequently withdrew the proposal. In short, not only is the question of stabilization complex, but there is also insufficient legislative experience upon which to base general substantive provisions. Consequently stabilization too is left to rulemaking by the Commission under paragraph 12.11(b). Thus section 12.11 authorizes the Commission to enact regulations dealing with any stabilizing activities and with activities that go beyond "stabilization" in connection with a distribution.

103 3 L. LOSS at 1584; *see also* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, ss. 1309(a)-(b), Comment (2).

Part 13

Civil Liability

Civil liability is central to the scheme of the Draft Act. Part 13 contains all the provisions creating civil liability and attempts to deal with it comprehensively, albeit not exhaustively, in order to ensure that any person who suffers harm as a result of improper conduct in the securities market or in connection with a transaction in securities may be compensated. Thus any violation of the Draft Act may give rise to civil liability under the Part.¹

Although the ideal of compensation for all damage caused by a violation of the Draft Act is easily stated, it is less easily implemented. All of the types of harm that may result from the various violations cannot be precisely foreseen. Moreover, some requirements of the Draft Act are more basic to the scheme and to investor protection than others and it may therefore be necessary to prescribe more stringent liability standards for their violation.

At least equally important, the nature of the securities market itself poses substantial difficulties for the development of an equitable scheme of compensatory liability. While there are few problems with face-to-face transactions, in an impersonal market like a stock exchange the link between traders, if it is discoverable at all, is usually largely a matter of chance. As a result all persons trading in the market during the period of a violation are likely in the same position in relation to the wrongdoer and full compensa-

1 See generally, Leigh, ch. I.B.

tion for all would frequently impose liability out of proportion to the violation.

Part 13 attempts to meet these difficulties in a number of ways. Common types of transactions are dealt with specifically and remedies for other types of violations are left to be fashioned by the courts in a manner consistent with those specified in the Part. Part 13 also distinguishes between direct and impersonal transactions in order to establish standards of liability appropriate to each in light of the nature of the transaction or document involved. Thus transactions involving a concerted selling effort such as a public distribution or takeover bid are separately treated as are manipulative conduct and the various types of disclosure documents required under the Draft Act. And, depending upon factors such as the importance of the document, the benefits to the person publishing it and the nature of the conduct involved, the standards for liability under part 13 range from strict liability for an issuer in a distribution through negligence for other participants to common law fraud, that is, knowing or reckless deception, for documents such as press releases. In a number of instances the standards are incorporated in a defence available to a defendant.

The general approach of part 13 is to create, in effect, a presumption that a violation of the Draft Act causes harm to investors affected by it and to permit a defendant to rebut the presumption in the manner specified. In cases of nondisclosure or market manipulation this approach is necessary if investors are to be compensated at all; but in other circumstances where the equities are not as clearly in the plaintiff's favour, the burden of proof remains with him. The latter solution is also adopted in connection with violations for which no specific remedy is provided but which are left to the residual discretion of the courts, for example, an action based upon deceptive conduct in violation of section 12.01.

The approach described above could, without more, result in enormous damage awards for a violation involving impersonal trades or nondisclosure. The Draft Act, in order to avoid the imposition of draconian liability, adopts an obvious compromise; it diminishes the amount of compensation available to investors by imposing ceilings on the potential liability of a defendant in an attempt to achieve a fair balance between its compensatory aims and punitive consequences.

The liability in part 13 for improper market conduct cannot be fully enforced in all circumstances if class actions are not available in respect of impersonal transactions. (The power of the Commission in part 14 to bring such an action on behalf of investors will probably not be sufficient to provide a remedy for all violations).

However, the Draft Act does not attempt to provide a class action procedure; rather, procedural matters, including class actions, are left to the rules of the court in which an action is initiated. The rules of court in the various jurisdictions in Canada will probably develop procedures for class actions in order to meet the growing consumer demand for them.

Because of the comprehensive scheme of civil liability contained in it, part 13 elicited far more discussion than any other part of the Draft Act. More specifically, the concept of an action based on impersonal transactions which enables all persons trading opposite a wrongdoer to recover damages defied a clear consensus. Impersonal actions pose a true dilemma. In the absence of a right of action for impersonal trades, even an investor who suffers a large, demonstrable loss as a result, for example, of a manipulative scheme has no remedy at all. It is little comfort to him to know that the manipulator must pay a substantial fine for his misconduct, especially where the manipulator is the issuer of which the investor is still a securityholder. On the other hand, the introduction of an impersonal action necessitates a ceiling on the amount of damages that a wrongdoer may be forced to pay and may result in a reduction of the award available to persons who suffer harm as well as the implicit inclusion in the Draft Act of many of the complexities that inhere in class actions.

Part 13 reflects a compromise solution. There are substantial questions about the efficacy of a market remedy, including that in part 13. Nevertheless, despite considerable skepticism and despite the strenuous objections of Warren M.H. Grover who considers the remedy to be inappropriate*, the advisers concluded that an impersonal market remedy should be expressly included in the Part to highlight its application and to provide a focus for debate over whether it should be retained.

* It is the view of Warren M.H. Grover that the whole concept of a market remedy as suggested in this part is wrong in theory and dangerous in practice. Nobody questions the proposition that a wrongdoer should not be left with the fruit of his wrongdoing, but it is a large jump from there to allow investors to form a lynch mob through some form of class action. In many cases the rewards to the individual investors will be windfalls, insubstantial to most, but substantial in the aggregate. The investors do not have to prove causation, it is presumed. The defences are illusory in most situations because of the impossibility of knowing why the stock market moved the way that it did with respect to a particular stock. The temptation to unscrupulous plaintiffs, and to unscrupulous lawyers, is only too real. The defendant is usually forced to settle. Even to permit the Commission to launch such an action is fraught with danger both because the Commission is likely to prosecute only a few selected cases, which may be chosen for the wrong reasons, and because the Commission must bear a substantial extra administrative burden at a time when less rather than more regulatory intervention in the marketplace is desirable.

It is apparent from the foregoing that part 13 deals with a number of difficult issues for which, in the context of the securities market, there is little precedent in Canada, either legislative or judicial. As a result, experience elsewhere with these problems has been considered, especially experience in the United States where there has been a substantial amount of litigation and discussion concerning them. A chart summarizing the types of conduct that may give rise to liability, the standards for and defences to liability, and the nature of the remedies granted is included at the end of the Part to provide a ready overview of the civil remedies granted under it.

Section 13.01

Section 13.01 contains definitions of two terms that are applicable only to this Part of the Draft Act. As is generally the case with such provisions, the section defines terms and concepts that are central to the Part and, therefore, frequently used in it.

Subsection 13.01(1): “Direct and Impersonal Trades”

Persons who buy and sell in an organized market such as a stock exchange require different remedies than do those dealing face to face. In the usual exchange transaction buyers and sellers make their trading decisions independently and are unaware of the identity of anyone trading on the other side. Who ultimately receives their share certificates, or whose certificates they in turn receive, depends on the vagaries of the exchange’s clearing system and is of little, if any, concern to them. The same is true of a trade in the over-the-counter market even if the person who ultimately buys or sells the securities happens to be a dealer. Paragraph (a) therefore defines direct and impersonal trades as mutually exclusive on the basis of whether the matching of buyers and sellers is “substantially fortuitous”. Although the phrase is not precise, it is clear that a transaction that is directly negotiated, even through agents, is direct regardless of whether it is “put through” or “crossed” on the floor of an exchange; thus a block trade and a sale of a security pursuant to a “stock exchange takeover bid” would both be direct. Conversely, an over-the-counter transaction placed through a broker or even directly with a dealer may be impersonal as the dealer’s identity is of no concern to the person trading.² Nevertheless, as it might be argued that a dealer transaction is not

2 See ALI FEDERAL SECURITIES CODE, Tent. Draft. No. 2, s. 1401(b), Comment (4); Reporter’s Revision of Tent. Drafts Nos. 1-3, s. 1401(b), Note.

one in which matching is substantially fortuitous, the “but” clause is included in the subsection to put the matter beyond doubt. In short, even if privity of contract between two parties to a trade can be proved, it is not determinative of whether the trade is direct or impersonal.

Subsection 13.01(2): “Rescission”

The Draft Act generally grants a person who trades a security in a direct transaction in connection with which the other party to the trade commits a violation the right to rescind the transaction. Subsection (2) alters the common law remedy by incorporating a fungibility concept, so that an investor need not return the specific shares traded, and by imposing a duty on a plaintiff to mitigate his loss once he learns of the violation. The rescission remedy is thus adapted to the realities of an organized securities market. However, a plaintiff has a duty to mitigate only where it is reasonable to do so. Accordingly, where the security can neither be purchased nor sold by the plaintiff, that is, where it is not actively traded in the market or otherwise available, the duty in paragraph (2)(b) would not apply. Indeed, even without the reasonableness qualification this result would likely follow both at common law and under the Draft Act because a court may adapt a definition to the factual context in order to achieve just results.³ Similarly, the time at which the duty arises, that is, when the facts relating to the violation become public, is not inflexible but may be modified where the plaintiff actually learns of the facts at a different time, in which case the later time is the relevant one. The provision leaves this matter to be proved by the party to whose benefit it enures.⁴ And the usual principle that the plaintiff must return any benefits received also applies.⁵

The mitigation principle is also intended to minimize the difference between damages and rescission in order to reduce the role of tactical considerations in the selection of remedies and to avoid possible problems relating to the election of remedies. Paragraph (2)(b) therefore specifies the time that is usually used to determine the value of securities when an out-of-pocket measure of damages is applied.⁶ As a result a plaintiff’s recovery in an action for rescission may be less than it would be at common law. For example, if X purchases securities from Y in a fraudulent transaction at \$100, and the market price of the security falls to

3 *See* Interpretation Act, s. 14(2)(a).

4 *See* paragraph (2)(b).

5 *Cf.* ALI FEDERAL SECURITIES CODE, s. 1703(h).

6 *See* section 13.03, Commentary (discussion of damages).

\$50 when the facts become public and to \$25 by the time of judgment, X's actual recovery is \$50. (He receives \$75, that is, \$100 less the \$25 that the market price declines after the dissemination of the facts, but he must return the security which is worth \$25 for a net recovery of \$50.) The amount is therefore equivalent to the probable damage award in a similar action.⁷

Rescission, as modified by subsection (2), is available in cases in which the transaction is likely to involve a marketable security and, therefore, in which a duty to mitigate is appropriate. It is granted for transactions involving distributions (section 13.05), takeover bids (section 13.06) and insider trading (section 13.03). However, where a violation does not involve any question of dissemination of information or risk of the market or where it is otherwise inappropriate to impose the risk of the market on a plaintiff, the common law rescission remedy is retained.⁸ Nevertheless, whatever the nature of the rescission remedy, the equitable defences continue to be available. Thus although the importance of a defence of laches is diminished by the duty to mitigate, it may be raised in appropriate circumstances, as may a plaintiff's acceptance of benefits resulting from a transaction after he learns of the violation.⁹ Finally, the action is always subject to a "rescission offer" by a defendant made pursuant to section 13.20.

Section 13.02

Section 13.02 follows the approach in Ontario Bill 7 and creates strict liability in rescission or damages for engaging in a distribution without filing a prospectus. As under the source provisions the remedy is available only to a person who purchases *in the distribution*.¹⁰ However, subsection (1) departs from the Ontario source provision, which requires privity of contract, by making the issuer, secondary distributor and underwriter liable to any person who purchases in the distribution on the basis that the parties who primarily benefit from and are primarily responsible for a distribution should bear ultimate liability for all transactions in connection with it. The Draft Act thus provides a middle way between liability to all persons who purchase during the period of a distribution and a privity requirement and may therefore be

7 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, ss. 1402(e)-(f)(1), Comment (5)(b).

8 See e.g. sections 13.02 (sale of security in distribution where no prospectus filed), 13.14 (registrants' conflicts of interest).

9 See generally *Gannett Co. Inc. v. Register Publishing Company*, 428 F. Supp. 818 (D. Conn. 1977).

10 Cf. e.g. *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *Peek v. Gurney*, L.R. 6 Eng. & Ir. App. 377 (1873).

sufficient to deal with distributions through the facilities of a securities exchange.¹¹ In any event, as the major purpose of the section is deterrence rather than compensation, it may not be unreasonable to omit a general remedy for the market and to rely on the criminal sanction in part 14 and on the more limited liability under this section.

Subsection (2) imposes liability on members of the selling group who do not themselves participate in the structuring of a distribution but rather rely on the underwriter to ensure compliance with the Draft Act. (The definition of “underwriter” includes only members of the underwriting group.¹²) Although their liability under the section is also strict, it is limited by the number of securities actually sold by them, for they are liable only to persons who purchase from them (“*his purchaser*”).

Nevertheless, as liability under the section is strict, persons who inadvertently engage in a distribution may be caught by it. For example, a holder of securities may make a block distribution without realizing it and a member of a “selling group” may find himself in a similar position.¹³ In such circumstances the measure of liability specified in subsection (3) may be too harsh, especially as it excludes the mitigation principle in subsection 13.01(2) in order to emphasize the deterrent aspect of this section. Presumably for this reason the source provision was deleted from the Ontario bill after second reading.¹⁴ And for the same reason a provision based on the United Kingdom Companies Act, 1948,¹⁵ was added to the final version of the *ALI Code* to ameliorate the potentially harsh effects.¹⁶ The Draft Act preserves the section but adopts the code’s solution in subsection (4) so that a defendant who proves that he was not at fault, or was only slightly at fault, may avoid the full rigour of the deterrent remedy in subsection (3). However, it is expected that the courts will view the burden of proof under subsection(4) as a heavy one and will modify the remedy only to the least extent warranted so as not to detract from the provision’s purpose.

Section 13.02 does not create a remedy against an issuer that trades a security of its own issue while in violation of section 4.02 (requiring registration of issuers) or against a person who trades in violation of section 8.01. The other provisions of part 13 deal with most circumstances in which the former conduct would occur

11 See sections 5.14, 11.07; *cf.* ALI FEDERAL SECURITIES CODE, s. 1702.

12 See section 2.49 and Commentary.

13 See section 2.17 and Commentary; and see part 6.

14 See Ontario Securities Act, 1978, s. 130.

15 11 & 12 Geo. 6, c. 38, s. 448 (1948).

16 See ALI FEDERAL SECURITIES CODE, s. 2007 and Notes.

and the inclusion of the latter conduct would involve double liability in that a broker would be liable to both parties to a trade. In both cases liability is likely to be out of proportion to the offence, especially if the failure to register was an oversight based on ignorance.¹⁷ As a result, liability for such violations is left to be implied by the courts under section 13.16 in appropriate circumstances.

Section 13.03

Section 13.03 creates liability for insider trading in direct transactions and for improper "tipping" of confidential information that results in a direct trade in violation of section 12.02. (Liability for a violation of section 12.02 in connection with an impersonal trade is treated in section 13.04.) The structure of the section indicates the burdens of proof established under it; subsections (1) and (2) simply create liability for a violation of section 12.02 in connection with a direct trade in a security, so that liability against a person who trades or informs flows automatically once the specified violations are proved unless the defendant can avail himself of a defence under subsection (3). In effect, therefore, the section creates a presumption of liability that a defendant may rebut by proving that the plaintiff knew or should have known the confidential information. And a defendant may also avail himself of the defences specified in section 12.02. The approach with respect to a rebuttable presumption has been adopted throughout part 13 and is necessary if an effective remedy is to exist for violations in connection with impersonal trading.¹⁸ (Liability for violations involving impersonal trades raises a number of considerations not relevant to direct trading.¹⁹)

Insider trading is the *sine qua non* for liability under the section. If an insider trades himself he is liable to the person with whom he trades for rescission or damages, and if a person who receives confidential information as a result of an insider's tip trades, the insider is liable for damages to the person with whom his "tippee" or "subtippee" trades.²⁰ Subsection (2), however, provides that an insider is liable only if his tippee or subtippee himself trades contrary to section 12.02. This condition ensures that a tippee's trades must be executed in connection with the information and thus avoids a potential interpretation of the section that might have imposed liability where the actual trade does not

17 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1401(a), Comment (5).

18 See subsection 13.01(1) and Commentary.

19 See section 13.04 and Commentary.

20 Cf. Ontario Securities Act, 1978, ss. 131(1), (2).

involve a violation. Moreover, it ensures that the liability of tippers, tippees and subtippees is coextensive by allowing a tipper-defendant to avail himself of the defences in section 12.02 in relation to his tippee's trades. And all are jointly and severally liable under section 13.18. As it is arguable that the present Canadian legislation imposes liability on a tipper for the trades of his tippees, the only extension in the section is to make a person who informs liable for the trades of his subtippees as well.²¹

The defences available under the section are as broad as those in the present Canadian legislation. The prohibition in section 12.02 is not applicable where an insider reasonably believes that the information is not confidential or that the other party is aware of it. (The latter standard is the converse of the defence in subsection (3) and is equivalent to a similar one in the present statutes.²²) A similar defence is available under paragraph 12.02(4)(b) to a person who informs another. Moreover, even if a violation of section 12.02 is proved, a defendant may escape liability by proving that the plaintiff knew or should have known the confidential information. However, the section, unlike the judicial interpretation of the provincial acts and the new Ontario act, does not permit a defence that a person who traded did not "make use" of confidential information of which he was aware.²³

Although the *ALI Code* specifies the measure of damages for actions brought under its provisions, the Draft Act does not.²⁴ Rather, as a residual judicial discretion to modify the measure in appropriate circumstances would be necessary in any event, it leaves the question of damages to be determined by the courts in particular cases. It is expected, however, that the basic measure of damages for all deceptive conduct, including insider trading, will be an out-of-pocket measure modified as necessary to fit the context of the securities market. Although the out-of-pocket measure of damages, applicable at common law to fraudulent misrepresentations, is the difference between the value given by the plaintiff and the value received by him at the time of the transaction, in a securities transaction involving a misrepresentation or nondisclosure the value of the security can best be determined after the true facts are disclosed and the market price has adjusted in light of them, that is, when "the market price ceases to be fictitious".²⁵ Thus the time specified in the definition of "rescis-

21 See e.g. *Anisman* at 222-23.

22 See e.g. Ontario Securities Act, s. 113.

23 See section 12.02, Commentary; cf. Ontario Securities Act, 1978, ss. 131(1)(c), 131(2)(c).

24 See e.g. ALI FEDERAL SECURITIES CODE, ss. 1703(i), 1708(a), (b).

25 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, ss. 1402(e)-(f)(1), Comment (1)(b).

sion" is the time when the material facts relating to the violation have been disclosed and generally disseminated.²⁶

Nevertheless, in some cases, for example where a plaintiff seller proves that he would probably have sold at the highest intermediate price if not for the violation, a conversion measure of damages may be preferable to the out-of-pocket measure. In fact the leading Canadian decision on insider trading suggests this measure in a *dictum* and the Ontario Securities Act, 1978, has adopted a variation of it.²⁷ And if the plaintiff sells a security of the class purchased before the action, his actual damage is the difference between his purchase price and the sale price and the converse is true if the violation involves a sale by the plaintiff.²⁸ It is expected as well that the courts will imply a duty to mitigate analogous to that required for rescission under subsection 13.01(2).

Although the measure of damages under the section is the same for insiders who violate section 12.02 by trading and by informing, it may not be the same for their accountability to an issuer under subsection (4). Under the latter provision a violator is accountable only for the "direct benefit or advantage...received or receivable" by him and it is likely that the benefit received by a tipper as a result of his violation, if any is receivable, will be less than the amount receivable by the person who actually trades. As a tipper is likely to benefit less than an insider who trades, it is not inequitable that his accountability to the issuer be similarly limited; this solution is reinforced by the analogy of a fiduciary's liability to his beneficiary at common law. In either case subsection (4) permits the imposition of a "penal" liability as it applies regardless of whether a remedy is obtained against a violator under subsection (1) or (2).²⁹

Accountability to an issuer is slightly more extensive under the Draft Act than under the Ontario Securities Act, 1978. Subsection (4), like the new Ontario act, makes only primary insiders accountable to an issuer for their profits and excludes tippees on the basis that the fiduciary relationship between an issuer and a

26 See paragraph 13.01(2)(b), Commentary; and see generally, Yontef, ch. III.C.10; Anisman at 243-52.

27 See *Green v. Charterhouse Group Canada Ltd.*, 12 O.R. (2d) 280, 313-14 (Ont. C.A. 1976); Ontario Securities Act, 1978, s. 131(6) (court shall consider average market price in 20 days after general disclosure made but may also consider other measures).

28 Cf. ALI FEDERAL SECURITIES CODE, ss. 1708(a)(1)(A), (2)(A); and see generally Mul-laney, *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 FORDHAM L. REV. 277 (1977).

29 Cf. Ontario Securities Act, 1978, s. 131(4).

person who merely receives information is less than clear.³⁰ (The limitation was adopted following the views of the advisers at a time when the Ontario bill was substantially the same.³¹) However, unlike the new Ontario act, the Draft Act includes as an “insider” persons whose relationship with an issuer gives them access to confidential information.³²

Section 13.04

Section 13.04 creates liability against a person who makes an impersonal trade with inside information or who conveys confidential information in violation of section 12.02 to another person who trades in an impersonal manner.³³ Thus the section provides parallel remedies to those under section 13.03 for insider trading or tipping in connection with a direct trade. The two types of trades are dealt with in separate provisions in order to emphasize that the remedies for violations in connection with direct and impersonal trading are mutually exclusive because of the market circumstances in which the latter type occurs.³⁴

Section 13.04 is limited to violations involving trading by the defendant (or in the case of tipping by his tippee or subtippee) as other violations for which liability is prescribed in this Part are either not readily susceptible to the direct-impersonal dichotomy or involve liability only where privity of contract exists. Thus sections 13.05 and 13.06 require privity of contract, or at least “indirect privity”, in order to recover for a false prospectus or takeover bid circular. Sections 13.07 to 13.10 deal with false statements made, in effect, into the marketplace in circumstances where trading by the person who makes them is irrelevant to their impact and therefore prescribe a remedy in damages only in relation to impersonal trading. And the same is true of the remedy for manipulative conduct concerning which it makes little sense to consider liability for direct trading.³⁵ Liability for such violations is dealt with only in connection with impersonal trading in order to reflect their market impact, and the limitations on liability for them differ in order to reflect the various bases for the liability.

The treatment of the burden of proof in section 13.04 is the same as that elsewhere in part 13. Once a defendant’s violation of

30 See e.g. *Yontef* at n. 207 and following; but see, *Anisman* at 171-72.

31 See Ontario Bill 7 (2d reading), s. 131(3).

32 See paragraph 12.02(1)(b); compare Ontario Securities Act, 1978, ss. 1(1)17, 131(7) (“insider” and “special relationship”).

33 See subsection 13.01(1).

34 See subsection 13.01(1) and Commentary.

35 See e.g. sections 12.06 (wash trading), 12.07 (manipulation by trading).

a specified prohibition is proved, liability is presumed unless he can avail himself of one of the defences under the section.³⁶ A rebuttable presumption is necessary to provide an effective remedy for trading in an organized market in which investors trade on the basis of their own decision but in reliance on the market's fairness. A misrepresentation, for example, although unknown to an investor, might affect the price at which he trades in a security. To require him to prove that the misrepresentation "caused" him damage would impose an unrealistically onerous burden upon him, and the same is true in the converse case of an improper failure to disclose material information when trading.³⁷

Whereas both rescission and damages are possible remedies for a direct transaction, damages alone are available for an impersonal one because of the difficulties of demonstrating privity of contract between buyers and sellers in an organized securities market.³⁸ In fact, a privity requirement would in effect deny a remedy for market transactions,³⁹ which has led one commentator to argue that the present Canadian insider trading provisions should be interpreted to achieve a result similar to the provisions of this section.⁴⁰ As a result, the remedy for impersonal trading contemplates the possibility of many plaintiffs and class actions. In order to avoid the likelihood of a minimal recovery to a large number of plaintiffs, it has been suggested that the plaintiff class in impersonal transactions be limited to persons who trade on the same day as and on the side opposite to the violator.⁴¹ This solution would have the added benefit of creating a "semblance of privity" because the trades are netted out in the exchanges' clearing systems on a daily basis but, despite its obvious advantages, it has not been adopted because it might deprive more deserving persons of a remedy. A purchaser of securities in the early stages of a deceptive scheme may suffer less harm than one who purchases later; for example, in the case of a misrepresentation the first purchaser might sell his securities before the true facts are known and thus suffer no loss, while the second or subsequent purchasers suffer substantial damages as a result of the violation.⁴² Subsection (1) therefore defines the plaintiff class to include any person who trades in the same security as the defendant (or his tippee)

36 See section 13.03, Commentary.

37 See e.g. *Blackie v. Barrack*, 524 F.2d 891, 907-08 (9th Cir. 1975); and see, *Yontef* following n. 292.

38 See subsection 13.01(1), Commentary.

39 See e.g. *Fridrich v. Bradford*, 542 F.2d 307, 324-25 (6th Cir. 1976) (*per* Celebrezze, J., concurring).

40 See, *Anisman* at 234-43.

41 Cf. *Fridrich v. Bradford*, *supra* note 39, at 326-27 (*per* Celebrezze, J., concurring).

42 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, ss. 1402(a)-(c), Comment (4).

during the period in which the violation may have an effect on its price, that is, between the time of the defendant's trade and the date on which the true facts become public.⁴³

Although the measure of damages is not expressed in section 13.04, it is expected that it will be analogous to that applied under section 13.03, that is, an out-of-pocket measure adapted to the context of the securities market, including the duty of mitigation in paragraph 13.01(2)(b). If a plaintiff does engage in trading after the transaction on which his action is based, such trades may be taken as mitigating events so that his damages become the difference between the price at which he initially traded and that of subsequent trades on the opposite side.⁴⁴ Thus in an action based upon impersonal trades the damages will be calculated on the basis of the number of shares traded by the plaintiffs.

A defendant may, however, reduce the amount of liability if he can avail himself of a defence under the section. Subsection (2) incorporates the defence available under the preceding provision. Thus a defendant may exculpate himself from liability if he can demonstrate that no violation occurred, and he may reduce the amount of liability by excluding particular plaintiffs under subsection (2).

More important in the context of market transactions is the quasi-defence provided by subsection (3), which permits a defendant to reduce his liability to the extent that he can prove that the plaintiff's loss was not caused by his violation. The provision is applicable only to impersonal transactions because it is inappropriate for direct actions that provide the alternative remedy of rescission.⁴⁵ The preposition "to the extent" is used to indicate that the subsection does not provide a complete defence but rather incorporates a principle of "comparative causation" so that liability is reduced only insofar as extraneous causes influenced the plaintiff's losses. It should be stressed that this defence may not be used to show that a violation could not have caused any damages at all because the trading occurred in an organized market⁴⁶ or that the damage was caused by the trading of a tippee or subtippee rather than the violation (informing), for such an interpretation would in effect negate subsection (1) which clearly contemplates a remedy in such circumstances.

As the defence is based on causation, it is inevitably somewhat imprecise. The new Ontario act attempts to specify a clearer measure of comparative causation for prospectus liability by

43 See section 2.31 ("public" information).

44 Cf. ALI FEDERAL SECURITIES CODE, ss. 1708(a)(1)(A), (2)(A).

45 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1402(f)(2), Comment (1).

46 Cf. *Fridrich v. Bradford*, *supra* note 39.

providing that a defendant is not liable for "any portion of such damages that he proves do not represent the depreciation in value of the security as a result of the misrepresentation relied upon" by a plaintiff.⁴⁷ However, the provision does not settle the problems as the "result" language imports notions of causation; and it is not appropriate to the Draft Act in any event, for the loss caused by a failure to disclose, that is, by a violation of section 12.02, is itself an imputed loss. The Draft Act therefore retains the causation language from the U.S. source provision as the concept of "cause" provides sufficient flexibility to enable the courts to take into account the effect on the price of a security of market factors unrelated to the violation.⁴⁸

Even with the defences available, the large number of potential plaintiffs and the likely measure of damages create the possibility that virtually unlimited liability might be imposed under the section. Such liability would be inordinately harsh, for example, against an insider who trades a few shares when in possession of confidential information. Consequently, even though the major purpose of the section is compensatory, subsection (4) imposes a ceiling on a defendant's liability for impersonal transactions. The maximum limits a defendant's liability to twice the amount for which he would be held responsible if his trades had been direct (subject, of course, to reduction if he proves the plaintiffs' failure to mitigate) and is therefore related to the number and price of securities traded by the defendant. The imposition of double liability results from a recommendation of the advisers and constitutes an attempt to achieve a compromise that would provide a higher level of compensation to investors without unduly penalizing persons who trade and would have a complementary deterrent effect on improper trading. Double liability was selected in view of the fact that such liability is already possible under the present Canadian legislation.⁴⁹ However, as accountability to the issuer is retained in subsection (8), it is possible that in some circumstances an insider who violates section 12.02 will be both liable under the section to persons who trade and accountable to the issuer.

As a result, the measure of damages under the section will likely be greater than a defendant's profit and should help to deter insider trading and tipping. For example, if X, in connection with a violation of the Draft Act which lasts ten days, trades securities by selling 100 shares into the market at \$100 on the first day of the

47 Ontario Securities Act, 1978, s. 126(7).

48 Cf. *e.g.* *Hughes v. Lord Advocate*, [1963] A.C. 837 (H.L.); *Petition of Kinsman Transit Company*, 338 F.2d 708 (2d Cir. 1964); *Petition of Kinsman Transit Company*, 388 F.2d 821 (2d Cir. 1968).

49 See *e.g.* *Anisman* at 251-52.

violation and 100 shares at \$75 on the ninth day, and the price of the shares drops to \$50 when the facts become public, he is liable for \$15,000, that is, $2 [100 (\$100 - \$50) + 100 (\$75 - \$50)]$ plus any consequential damages that an individual plaintiff may prove. It should be emphasized, however, that the limitation on damages in subsection (4) applies only after damages have been calculated on the appropriate basis.⁵⁰

Section 13.04 may not be effective in all cases if a class action procedure is not available. But part 13 does not prescribe one and the operation of the section is not contingent on the existence of such a procedure under the rules of court in the various jurisdictions in which an action may be brought. Nor, in fact, is the section limited to a class action; rather any person who traded during the period of a violation may bring an action under the section for damages on his own behalf. In light of the limitation on a defendant's liability under subsection (4), however, the potential for such actions gives rise to a number of problems. While individual actions are a necessary underpinning for section 13.04, their availability without further provisions would permit recovery only by those who happen to bring their actions first. In other words the first plaintiffs would likely recover the maximum amount possible under subsection (4) and later plaintiffs, although equally deserving, would recover nothing.⁵¹

This result is simply unacceptable. In order to prevent it, subsections (5) to (7) require proration of damages among a plaintiff class where the statutory limitation is exceeded and specify priorities for allocation among class members and possibly to others if the ordinary method of prorationing is not feasible. In short, the provision requires a court to distribute the amount among the class members insofar as it considers it warranted, so that the court has the flexibility to satisfy substantial claims but not small claims in relation to which the cost of prorationing would exceed the value to be received by individual plaintiffs. Any amount remaining is to be turned over to the issuer of the securities, unless the issuer committed the violation on which the action is based or unless it would be inequitable to do so, in which case the remaining amount is to be awarded to the contingency fund required under part 9 to be maintained by the self-regulatory organizations for the benefit of investors.⁵²

For proration to work effectively, however, it is necessary to know all of the plaintiffs in all jurisdictions as of the time at which

50 Cf. ALI FEDERAL SECURITIES CODE, s. 1402(f)(2), Comment (1).

51 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1409, Comment (1).

52 Cf. ALI FEDERAL SECURITIES CODE, s. 1711(j).

it is done, and they must also be parties to the action so that they will be bound by it. Some procedure is required, therefore, to consolidate actions under provisions of the Draft Act that impose a ceiling on liability. Although earlier versions of this Part contained a provision prescribing such a procedure, it was determined not to include it in the Draft Act but rather to indicate in the Commentary the need for such procedures and the alternatives considered in the preparation of these *Proposals* in the expectation that the Commission will undertake to develop appropriate procedures in cooperation with the Canadian Judicial Council, the provincial superior courts and the Federal Court of Canada.

A number of solutions to the procedural difficulties are possible. The *ALI Code*, ss. 1711(a)–(i), adapts to its context and extends to the whole of an action the procedure for consolidation of actions in the United States federal courts under which the Judicial Panel on Multidistrict Litigation consolidates actions based on the same facts and transfers them for pretrial dispositions to the district court in which it is most convenient to hear them.⁵³ As there is no institution in Canada analogous to the Multidistrict Panel in the United States, the initial version of this Part gave similar powers to the Commission by requiring that it be notified of all actions under the section and authorizing it to consolidate them in the superior court in Canada that is most convenient. However, in discussions among the authors it was concluded that the Commission is not an appropriate body to determine alone questions of interjurisdictional consolidation.

Where two actions arising out of the same facts are brought in different provinces against the same defendant, the normal practice in Canada is to stay the later action pending the decision in the earlier one. But, except in a class action, this practice would not be workable under the Draft Act in light of the ceiling on damage awards and the consequent prorationing. As a result, another version of part 13 required all actions for which a maximum damage award is specified to be brought in the Federal Court – Trial Division, and authorized the Commission to make rules in conjunction with the Canadian Judicial Council providing procedures for consolidation of such actions.⁵⁴ The section, which adapted the provisions of Bill C-42,⁵⁵ would have permitted an action to be brought as well in any provincial superior court that adopted the rules so developed in order to avoid limiting such actions under the Draft Act to the Federal Court.

53 See 28 U.S.C. s. 1407 (1976).

54 See e.g. *Leigh*, ch. I.B.17.

55 See Bill C-42, An Act to amend the Combines Investigation Act, ss. 39.1, 39.23 (1977).

As section 13.04 now stands, an action may be brought in any provincial superior court and in the Trial Division of the Federal Court. It is likely that the Commission in conjunction with the Canadian Judicial Council can develop procedures for interjurisdictional consolidation of actions under the Draft Act as is demonstrated by the rules adopted pursuant to the United States Judicial Code.⁵⁶ Indeed, in formulating such rules the experience of the Multidistrict Panel would undoubtedly be utilized. And subsection 16.05(7) authorizes the implementation of any rules that are so developed.

Section 13.05

Section 13.05 creates civil liability for a false prospectus, whether it is misleading when it is filed or becomes so afterward and is not amended before an investor purchases a security covered by it. As a duty to amend a prospectus exists only while a distribution is in progress, there is no liability for failure to do so after the distribution is completed.⁵⁷ Although a “misrepresentation” includes an omission of a fact that makes the statements made misleading, it does not include a fact that does not do so, even if it might influence an investor’s decision.⁵⁸ As a result the latter type of omission is expressly included in subsection (1).

The present provincial securities acts provide rescission for a period of ninety days and authorize a damage action only against directors of the issuer and officers who sign the certificate in a prospectus. Thus liability for a false prospectus under the securities acts is quite limited and they have, as a result, been the subject of some criticism.⁵⁹ Section 13.05, while adopting the general approach of the Canadian source provisions in creating a remedy only for persons who purchase securities offered by a prospectus pursuant to the distribution, varies from them in substantial detail, as does the new Ontario act, and adheres to the approach in section 13.02.

Subsection (1) makes the issuer, selling securityholder and underwriter liable for rescission or damages to any person who purchases a security in the distribution, and subsection (2) makes the persons specified in it liable for damages. The Draft Act thus provides a reasonable middle ground between the present Ca-

56 See 28 U.S.C. s. 1407; Rules of Procedure of the Judicial Panel on Multidistrict Litigation, 78 F.R.D. 561 (effective August 1, 1978); and see Weigel, *The Judicial Panel on Multidistrict Litigation, Transferor Courts and Transferee Courts*, 78 F.R.D. 575 (1977).

57 See section 5.12.

58 See section 2.24.

59 See e.g. P. ANISMAN at 320-26.

nadian legislation, which grants a remedy in damages alone, and the U.S. source provision which creates liability to any purchaser of a security of the class covered by the prospectus whether or not pursuant to the distribution. Section 13.05 retains the requirement that a plaintiff must purchase a security "in the distribution" and authorizes an action for damages against the persons specified in subsections (1) and (2), but it also removes the need to prove privity of contract in order to obtain rescission against the issuer, selling securityholder or underwriter.⁶⁰ Thus purchasers who purchase in a distribution may receive the full amount that they paid for the securities. (The Ontario Securities Act, 1978, reflecting a slightly different compromise, also permits rescission but only where the purchaser can prove that he purchased the securities *from* the issuer or underwriter.) It is worth stating that a purchaser of "a security covered by the prospectus in the distribution" is intended to include a buyer of securities purchased by an underwriter for stabilization purposes in connection with the distribution and subsequently sold by him during the period of the distribution.

It must be admitted that the solution to the question of prospectus liability in the Draft Act embodies a compromise. A distribution of a security that is also traded in the secondary market affects the market for the security. All purchasers may avail themselves equally of the prospectus and will likely neither know nor care whether the security they purchase comes from the distribution or from a previous one. Their inability to determine the source of the security is reinforced by the fact that section 5.04 requires that a prospectus be sent to all purchasers of the class of security during the distribution, however their purchase is filled. And the difficulties are increased where a distribution is made on the floor of a securities exchange pursuant to section 5.14, for the matching of purchasers and sellers is then only rarely possible. In short, not only does a remedy limited to purchasers in a distribution depend on the happenstance of how an investor's order is filled, but it may also be difficult for the investor himself to discern whether he has a remedy.⁶¹

However, a remedy available to any person purchasing a security of the class covered by a prospectus, as under the *ALI Code*, must result in the denial of a rescission remedy. Moreover, as full damages would be out of all proportion to the benefits of a sale of securities, no issuer would distribute to the public and the purpose of the Draft Act would be undercut. A ceiling on liability would thus be necessary and such a limitation would result in each

60 See section 13.02, Commentary.

61 Cf. sections 11.06, 11.07 and Commentary.

purchaser recovering only a small portion of the money paid for the securities because of the need to prorate the damages awarded.⁶² In short, neither alternative is fully satisfactory. The Draft Act therefore limits the traditional prospectus remedy to purchasers in a distribution and grants any of them a right of rescission as well as damages, while leaving persons who purchase other securities of the same class during the period of the distribution to obtain a remedy under section 13.09 (false filings) which requires a higher standard of proof.

The potential defendants under section 13.05 are substantially the same as those specified in the new provincial legislation except for two relatively minor differences. Instead of imposing liability on persons who sign the certificate in a prospectus, paragraph (2)(c) specifies the officers of a corporation who usually do so and paragraph (2)(b) includes proposed directors named, with their consent, in a prospectus. Although proposed directors are not subject to liability under the new Ontario act, the inclusion of their names may give credibility to an issuer and encourage purchases of the securities being distributed. Persons who permit their names so to be used should be subject to the same duties as persons who are already directors.

No person is liable under section 13.05 if he proves either that the plaintiff knew the truth when he purchased or should have known it because the prospectus was amended.⁶³ In such circumstances a purchaser has only himself to blame and should not be entitled to the statutory remedy. However, no general duty to discover information is included in the defences under this section because a purchaser of a security in a distribution is, unlike a purchaser in an ordinary market transaction, subject to a sales campaign initiated by the seller. For similar reasons, where a correction has been made to a prospectus, the final clause in subsection (4) permits a plaintiff to recover where he proves that he justifiably relied on the prospectus even though the correction was public. This provision is analogous to the time specified for rescission in paragraph 13.01(2)(b), that is, the time when an investor actually learns the truth, and it provides the courts with the flexibility to devise just results in individual cases.

In most circumstances there is no reason to permit an issuer to retain the benefits of a sale of shares pursuant to a prospectus containing a misrepresentation. Even if the issuer takes reasonable care, the risk of a misrepresentation should be borne by it rather than by an innocent purchaser. An issuer on whose behalf

62 See section 13.04 and Commentary.

63 See subsections (3), (4).

securities are being distributed is therefore absolutely liable for a misrepresentation or omission in the prospectus relating to the distribution except in a few specified circumstances in which such liability would be unfair or unduly onerous. An issuer may, like any other person, avail itself of the defences in subsections (3) and (4), for in the circumstances specified in them a purchaser cannot justly hold the issuer responsible for his loss. Similarly, it would be too heavy a burden to require an issuer to act as an insurer of the accuracy of documents filed by an unaffiliated corporation; thus an issuer that must include in its prospectus information concerning an unrelated corporation, for example, one that it intends to acquire with the proceeds of the distribution, is entitled to the defences in paragraphs (6)(c) and (d) in relation to that information.⁶⁴

There is also no reason to hold an issuer absolutely liable if it does not receive the benefits of a distribution. Consequently where a distribution is made exclusively on behalf of a shareholder, the issuer may avail itself of all of the defences in the section. The provision extending the defences to the issuer in such circumstances is new⁶⁵ and although the standard under the section is higher than for some of the documents from which information in the prospectus may have been derived, it is not for others.⁶⁶ In the circumstances it is a reasonable middle ground, especially as a secondary distributor will usually control the issuer.

However, an issuer is not entitled to the defence in subsection (5) in respect of a failure to amend a prospectus. Subsection (5) excludes an issuer for reasons similar to those underlying the imposition of strict liability in a distribution from which it benefits. It is fairer to place the risk of subsequent events on an issuer than on the purchasers of the securities. In fact, although an early version of the *ALI Code* allowed a similar defence to an issuer, the final version does not.⁶⁷ A secondary distributor may avail himself of the defence because he is less likely to be in a position to determine when matters in a prospectus become misleading.

Similarly, subsection (8) permits a selling securityholder to use the defences in paragraph (6)(c) in respect of parts of the prospectus based on information derived from documents or reports of the issuer. Because he is not responsible for them he is entitled to a defence of due diligence. (In any event as a controlling shareholder he may be secondarily liable for misrepresenta-

64 See subsection (7).

65 See subsection (7), second clause.

66 See e.g. sections 13.09, 13.07, respectively.

67 See ALI FEDERAL SECURITIES CODE, ss. 1704(e)-(f) and Note (3); Reporter's Revision of Tent. Drafts Nos. 1-3, s. 1403(d)(2).

tions in the issuer's documents.⁶⁸) The defence is based upon Ontario Bill 30, s. 129(4) and *ALI Code*, s. 1706. It is, however, narrower than the former provision which allows the defence to a selling shareholder for the complete prospectus and broader than the *ALI Code*, s. 1706(b), which requires that the selling securityholder (and the underwriter of a secondary distribution) know of the misrepresentation in the source documents before he may be held liable. As the selling securityholder obtains the benefit of the distribution and as his liability is limited to the extent of the securities distributed, a negligence standard seems more appropriate.

Subsection (8) differs substantially, however, from the parallel provision in the new Ontario act. On second reading Ontario Bill 7 contained the same provision as Bill 30 accompanied by a similar defence available to experts for statements made with their authority. The latter defence, however, did not place the burden of proof on the expert; rather it would have required a plaintiff to prove that the expert did not reasonably investigate or did not have reasonable grounds to believe that a prospectus did not contain a misrepresentation.⁶⁹ The act as passed extends a similar defence to all persons other than the issuer and selling securityholder. Thus the original source provision for subsection (8) has been transformed into a provision that would require a plaintiff to prove a lack of due diligence on the part of any defendant listed in subsection (2) and also on the part of an underwriter.⁷⁰ Given the dearth of decisions in Canada and elsewhere holding directors, officers and experts liable under similar provisions containing a reverse onus, there seems little reason to change the provisions to protect them further. As is apparent, the Draft Act does not attempt to follow suit but rather follows the approach to the burden of proof adopted in other provisions of this Part.⁷¹

The Ontario Securities Act, 1978, s. 128, and the *ALI Code*, s. 1704(g), specify that the standard of reasonableness for the purposes of the defences under this section is that of a prudent man in the circumstances. The Draft Act does not contain a similar provision because the courts will likely apply the same standard in their interpretation of "reasonableness". In doing so it is expected that they will take into account factors like those specified in the *ALI Code*, namely, (1) the type of issuer involved, (2) the type of person including consideration of his knowledge apart from his position, (3) the office held by a person with the issuer, (4) whether a

68 See section 13.17.

69 See Ontario Bill 7 (2d reading), ss. 126(4)-(5).

70 See Ontario Securities Act, 1978, ss. 126(4)-(5).

71 See e.g. section 13.03, Commentary.

director or proposed director is also an officer of the issuer or is otherwise retained by it, (5) the reliance placed on officers, employees and others whose duties should give them knowledge of the particular matters in issue in light of the responsibilities and functions of a defendant with respect to the issuer and the prospectus, (6) the nature of the underwriting, the role of the underwriter and the availability to him of information with respect to the issuer, and (7) whether a defendant had any responsibility for a fact or document incorporated by reference into a prospectus.⁷²

The meaning of "rescission" under section 13.05 is that specified in subsection 13.01(2), and where damages are sought the courts are likely, as under previous provisions, to apply an out-of-pocket measure. In fact, the leading decision on this measure of damages involved a distribution of securities.⁷³ As a result the mitigation principle implicit in the former definition is included in this section but the comparative causation principle applicable to liability for impersonal transactions under section 13.04 is not, despite the fact that the latter principle has been included in the new Ontario act.⁷⁴ It is doubtful whether a person who purchases a security on the basis of a misleading prospectus should be required to bear the risk of the market; the mitigation principle is sufficient to provide a fair balance.

Section 13.05 does, however, create a further limitation on the liability of individual underwriters. Subsection (9) limits an underwriter's liability to the total offering price of the part of the distribution that he underwrites.⁷⁵ The new Ontario act, s. 126(9), also limits the maximum damage recovery for a false prospectus to the price at which the securities are offered to the public. The Draft Act does not contain a similar provision as a purchaser's maximum recovery is the amount that he paid for the securities.⁷⁶

Section 13.06

A takeover bid circular is treated separately because it is a hybrid document. While a takeover bid involves a "sales effort" and imposes substantial pressures on offerees, its purpose is essentially not to sell securities, although a sale may be involved in a

72 See ALI FEDERAL SECURITIES CODE, s. 1704(g); see also ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION D-41 (1977).

73 See *McConnel v. Wright*, [1903] 1 Ch. 546 (C.A.).

74 See Ontario Securities Act, 1978, s. 126(7).

75 Cf. Ontario Securities Act, 1978, s. 126(6).

76 See e.g. *McConnel v. Wright*, *supra* note 73, at 554.

share exchange takeover bid, but rather to induce the shareholders of the offeree corporation to sell their shares.

Like the present provincial securities acts and the Ontario Securities Act, 1978, the Draft Act, with one difference, treats a takeover bid circular as equivalent to a prospectus for liability purposes. Thus an offeror is equated with an issuer or selling securityholder and has all of the defences available to them under section 13.05, the prospectus liability section. And all those who hold positions with an offeror like those held with an issuer by the persons enumerated in subsection 13.05(2) may be liable for a false takeover bid circular. However, because any securities purchased pursuant to a takeover bid go to the offeror, only he is capable of making rescission. As a result, a dealer manager, or an underwriter in a share exchange takeover bid, is liable only for damages under this section.

Subsection (1) creates, in effect, a duty to correct a takeover bid circular that becomes misleading as a result of events occurring subsequent to the date of the bid. The requirement is analogous to that in the *ALI Federal Securities Code*, s. 1602(b), as it applies to takeover bids. It is included in light of the fact that an exchange offer is exempt from the prospectus requirements and thus also from the requirement to amend a prospectus in section 5.12. And it is not unreasonable in respect of any bid in light of the pressure imposed on offerees. Nevertheless, because a bid is made in a market context, the duty to correct a circular arises only if the subsequent event is not public.⁷⁷

The defences available in an action for a false takeover bid circular are essentially the same as those for a false prospectus modified as necessary to take into account the context of a takeover bid. Thus whether an offeror in an exchange offer is an issuer, selling securityholder or some other person, the defences apply in the same way as they would to an equivalent person in a distribution.⁷⁸ Subsection (4), however, has been altered to reflect the fact that some offerees may have deposited their securities before an amendment is sent to correct a misrepresentation. The defence is available, therefore, only if the offeror extends a reasonable withdrawal right to such offerees or if the amendment is sent a reasonable time before the original withdrawal period has ended.⁷⁹

As under the preceding provisions, both rescission and damages are available to an offeree who accepts a takeover bid. The

⁷⁷ See section 2.31.

⁷⁸ See subsections (3), (5)-(7).

⁷⁹ See paragraph 7.22(a), section 13.20 and Commentary.

more limited remedy is appropriate for a false takeover bid circular, whatever the approach taken to other types of violation. While, for example, it is not unreasonable to treat purchasers in the market and those who purchase in a distribution alike because a distribution affects the market price of the security distributed, the same is not true of a takeover bid. An offeree may not only accept a bid, but he may also sell his securities in the market during the bid period at an inflated price resulting from the bid, and in a share exchange bid he may purchase securities of the class offered in the open market as well. In short, the number of variables is simply too great to be adequately subsumed within a single liability provision.

However, nonaccepting offerees and offerees who sell in the market because of a misrepresentation in a takeover bid circular are not without a remedy under the Draft Act. An offeree who sells his securities in the market may have a cause of action under section 13.09, and nonaccepting offerees may obtain a remedy under section 13.12.

It is therefore possible that an offeror will be liable both to accepting offerees and to offerees who sell their shares in the market. While it may at first appear anomalous to impose greater liability on an offeror than on an issuer who makes a distribution, there are good reasons to distinguish the two cases. An issuer's sole benefit is the money received from the distribution, whereas an offeror stands to benefit by acquiring the offeree corporation, often on the basis of a bid for less than all the shares. Thus the indirect benefits of a takeover bid may be greater in the long term. Moreover, an offeror is aware of the market displacement and the potential diversity of effects that a bid may cause. If he chooses to make a takeover bid, he should not be permitted to escape liability for its direct effects. And in any event similar liability may be imposed on an issuer under subsection 13.09(1).⁸⁰

Section 13.07

Sections 13.03 to 13.06 impose civil liability on persons who violate the Draft Act primarily in connection with their own trading. Section 13.07 and the sections following deal with violations that affect or are directed at the market and that are likely, directly or indirectly, to influence investor decision-making or the market price of the security involved, for example, by misrepresentations or manipulative practices. Consequently, unlike the preceding provisions, sections 13.07 to 13.10 create remedies only

80 See subsection 13.09(2).

for impersonal trading whether or not the person responsible for the violation himself trades.

If a defendant does trade, there may be some overlap between the causes of action in these sections and in those preceding. As the causes of action are independent an issuer may, for example, be liable under section 13.03 to a person from whom it purchases securities in a direct transaction and may also be liable under section 13.07 to all market traders. In such circumstances the maximum liability under subsection 13.07(5) would be in addition to any liability for the direct trading. Where the issuer's trading is impersonal, however, the plaintiff class would likely be the same under both sections 13.04 and 13.07 and the maximum damage award would be the greater of those permissible under the two sections.⁸¹

Section 13.07 deals with misrepresentations in a registration statement filed by an issuer under section 4.02. An issuer whose shares are publicly traded is required to file such a statement and, having filed, is entitled to the trading transaction exemption in section 6.04. The registration statement is thus the basic disclosure document in the Draft Act's continuous disclosure system. As the emphasis in the Draft Act is on issuer registration and continuous disclosure, there is little reason to treat it substantially differently than a prospectus.⁸²

The principles of prospectus liability in section 13.05 are therefore adapted in this section to registration statements. As the document relates generally to an issuer's activities, both purchasers and sellers who trade after it is filed may recover damages from the issuer. The phrase in square brackets in subsection (1) would, however, limit actions under the section to those brought by the Commission on behalf of investors pursuant to subsection 14.08(2). The square brackets are included to highlight the belief of two of the authors that an action under the section, as well as actions under section 13.09 which are also based on disclosure documents, should be so limited.* If the phrase is retained the

81 Subsection 13.07(5) is discussed in more detail below.

82 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1403, Comment (1). *But see* note*, following.

* Warren M.H. Grover and John L. Howard believe that full disclosure in understandable words is central to the effective operation of any securities market. Full disclosure is not advanced by imposing on the discloser vague and very extensive potential liability. While the proposed market remedy will likely prove to be rarely if ever used, its mere presence will cause issuers to be excessively cautious as to the kind, specificity and clarity of any disclosure made, especially disclosure of "soft" information such as qualitative evaluation of markets or forecasts of future growth or profits. It is better therefore to have more disclosure, with prosecution for false disclosure possible only at the instance of the Commission, than to have less disclosure and a theoretically broader remedy. The Commission can and should

defences in both sections relating to the conduct of individual plaintiffs would require modification, as they would then relate only to the distribution of any recovery, and an express limitation would be required in section 13.16 to preclude an implied action by an individual investor based on a misrepresentation in a disclosure document.

In accordance with the general approach of this Part, once the elements specified in subsection (1) are proved by a plaintiff, the burden shifts to the defendant issuer to establish one of the defences available under subsections (2) to (4). The standard of reasonableness and the factors for determining it in relation to the defences are, of course, the same as those under section 13.05.⁸³

The defences in subsection (3) are available to an issuer under this section.⁸⁴ As the issuer obtains no direct pecuniary benefit from its registration statement and certainly none from persons who trade in a market affected by its contents, there is no element of unjust enrichment underlying this section. An issuer is, therefore, no different from any of the other possible defendants in an action based on a false prospectus. The defence in subsection (4) is included for similar reasons and also because a registration statement involves no special selling effort.

The *ALI Code*, s. 1704, carries the analogy with prospectus liability further and makes the same persons (except an underwriter who is not involved in the preparation of a registration statement) who are liable for a false prospectus liable for a registration statement. The Draft Act does not follow suit but instead treats the registration statement like other continuous disclosure documents. Nevertheless, any such person involved in the preparation of a registration statement may be liable as an aider and abetter under subsection 13.17(1).

Section 13.07 creates no liability for a failure to correct or amend a registration statement that has been filed, as the continuing disclosure requirements in part 7A already impose an obligation on a reporting issuer to keep, in effect, its file current. This duty is particularly reinforced by the timely disclosure requirement of section 7.03. Section 13.09 creates civil remedies for mis-

prosecute if an issuer includes information in a registration statement that was intended to deceive the public. But the residual discretion should be exercised by the Commission at the prosecutorial level rather than by the court at the adjudicative level, because to leave the discretion with the court is to confer prosecutorial discretion on any allegedly aggrieved individual. The concern of the legal profession about the possibility of "strike suits" is not totally unfounded even if one concedes that such actions are constrained in Canada by judicial control of "spurious" class actions, the uncertain legitimacy in some provinces of contingency fees, and the party and party costs system.

83 See section 13.05, Commentary.

84 Compare section 13.05 and Commentary.

representations contained in such filings and section 13.16 authorizes the courts to fashion remedies as appropriate in the circumstances of each case for a failure to comply with the disclosure provisions in part 7A.⁸⁵

Because liability under section 13.07 is based on conduct of an issuer other than trading, it cannot be limited by the number of shares traded as it is under section 13.04.⁸⁶ But in view of the number of investors whose trading might be affected by a registration statement, some limitation is essential. Subsection (5) therefore imposes a monetary ceiling at a figure intended to provide some compensation to investors without unreasonably punishing a defendant.⁸⁷ As under section 13.04, the ceiling is applicable only after damages have been calculated in accordance with the appropriate measure.⁸⁸ And if the same misrepresentation is included in more than one document, the ceiling remains the same as liability is based on the misrepresentation rather than the number of documents in which it is included.⁸⁹ However, an issuer that knowingly makes a misrepresentation loses the benefit of the ceiling. It is worth noting that such knowledge must be proved by the plaintiff and that the standard is higher than for common law deceit in that recklessness alone will not nullify the limitation.

Subsection (5), in essence, establishes the maximum potential damages under the section in the statute itself. This result is clear in paragraphs (5)(a) and (b) which specify dollar amounts. Paragraph (5)(c), on the other hand, is intended to ensure that the maximum figures cannot serve to permit an issuer who files a false registration statement (or a person who violates another provision of the Draft Act treated in the succeeding provisions) to retain a benefit resulting from his violation. It thus permits a greater damage award than the specified amounts if an issuer derives a greater profit from trading during the period of the violation.

As mentioned above, some overlap exists between sections 13.03 and 13.04 and section 13.07. The provisions are, however, easily reconciled. If an issuer that files a false registration statement trades directly, the person with whom it trades is entitled to a remedy under section 13.03 and the issuer is also liable under this section. If the issuer engages in impersonal trading, it is liable under both sections 13.04 and this section, but to the same class of persons, so that its maximum liability will be the greater of the

85 See section 13.16, Commentary.

86 See subsection 13.04(4).

87 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1403, Comment (11).

88 See sections 13.03, 13.04, Commentary.

89 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1403, Comment (11)(h).

amount that would be awarded under section 13.04 or this section. This result is reinforced by the express reference to section 13.07 in paragraph 13.04(6)(a) and by the incorporation by reference of the prorationing provisions into this section.⁹⁰ (The section is expressly referred to in paragraph 13.04(6)(a), even though an issuer is covered by paragraph (6)(b), to ensure that subsection 13.04(6) applies to an action against a person who participates in a violation of this section.⁹¹)

Section 13.08

A directors' circular is required by the Draft Act to be sent to offerees, when they are subjected to pressures to sell their securities as a result of a takeover bid, in order to ensure that they receive information about their own issuer sufficient to enable them to decide whether to accept the bid.⁹² As well as providing information, directors frequently recommend acceptance or rejection of a bid and, even if they do not make a recommendation, the information disclosed in the circular may itself induce offerees to accept or refrain from accepting the bid. Moreover, in the context of a takeover bid offerees have an alternative option available; they may also sell their securities in the open market because of statements made in a directors' circular. A directors' circular, therefore, like a takeover bid circular, requires separate treatment in order to fashion the remedies relating to it to the peculiar context of a takeover bid.

Section 13.08 follows the approach in the provincial statutes and, like other provisions of this Part, presumes that all offerees rely on a directors' circular that contains a material misstatement. Thus directors and any other persons who sign a circular are liable to an offeree who trades or refrains from trading a security of the issuer to which the circular relates. The provision is not limited to persons who accept a bid in order to ensure the availability of a remedy to offerees who sell their securities in the market rather than to the offeror. However, the remedy in the section is limited to the persons for whom a directors' circular is intended, the offerees; other persons who trade as a result of a false directors' circular must fulfill the heavier burden of proof required under section 13.12.

The standard of liability for a false directors' circular is the same as that for a takeover bid circular or registration statement.

90 See subsection (6).

91 See subsection 13.17(1).

92 See section 7.25.

Once a material misstatement or omission is proved, liability follows unless a director or other defendant can avail himself of one of the defences specified in subsections (2) to (5) which incorporate the defences available under the preceding provisions, including the due diligence standard (subsections (3) and (4)) and the “comparative causation” defence (subsection (5)). Paragraph (3)(b), however, provides a further defence peculiar to a directors’ circular in that it takes into account the ability of a director to dissent from the statements of the majority and to have his dissent and the reasons for it included in the circular. The paragraph is also sufficiently broad to apply to the majority of the directors where a statement made by a dissenting director is false.⁹³

As with a registration statement, no liability is imposed for a failure to correct a directors’ circular that becomes misleading as a result of subsequent events. Most such events in connection with a takeover bid will be made public by the offeror, and those that relate to the offeree issuer will come within the duty to make timely disclosure under section 7.03. And as the Draft Act does not require the directors to make a recommendation in a directors’ circular, there seems little point in creating liability against them for a failure to alter a recommendation that has been made.

Section 13.08, like other provisions in this Part, does not specify the measure of damages to be applied to actions under it. Nevertheless, as with the preceding sections, it is expected that an out-of-pocket measure will be applied where an offeree trades, whether he does so by accepting the bid or by selling in the market. It is more difficult to specify a measure of damages for offerees who retain their shares because of the number of factors relevant to a determination of damages when the plaintiff has not traded. Although the measure of damages in most cases is likely to be the difference between the price paid for the securities pursuant to the takeover bid and the market or other available price of the security after the bid or when all the material facts become public, an offeree’s damages might also be affected by factors such as whether the bid is successful, whether the offeror exercises his option to take up all shares deposited even though the minimum condition attached to the bid is not met, the prorationing made on taking up shares deposited pursuant to a partial takeover bid, the impact of the directors’ circular on the bid’s failure and, of course, the offeror’s ability and intention to exercise a right compulsorily to acquire the shares of nontendering offerees. In light of the number of possible variables, it is expected that the courts will adopt the basic measure mentioned above and will modify it as appropri-

93 Cf. subsection 7.25(4).

ate in the circumstances of each case. And the person who desires that the basic measure be altered will bear the burden of proving the factors necessary to justify the alteration.

As directors and others who sign a directors' circular need not trade themselves, subsection (6) imposes a ceiling on damages similar to that under subsection 13.07(5) for registration statements.⁹⁴ However, subsection (6) contains only two paragraphs. The maximum of 1% of a defendant's gross revenues (up to \$1 million) in paragraph 13.07(5)(b) is designed to apply exclusively to issuers and is therefore omitted from this section which imposes liability only on individuals. Nevertheless, when subsection (6) applies, the prorationing procedure also applies. And again under this section the ceiling is not applicable where a plaintiff proves that a misrepresentation was made knowingly.

Section 13.09

Section 13.09 creates liability for misrepresentations in documents that are likely to influence trading in securities and are not covered in the preceding four sections.* Subsection (1) applies to reports and releases filed pursuant to the continuous disclosure requirements in part 7 of the Draft Act and thus is applicable only to the issuer (although other persons who participate in the violation may be secondarily liable under section 13.17). Subsections (2) and (3) deal with prospectuses, takeover bid circulars and block distribution circulars in the context of the market. And subsection (4) covers proxy solicitation material and all press releases and other forms of publicity that are not required to be filed and creates liability against the person responsible for the release.

As the documents covered by this section, other than a block distribution circular, do not generally relate to a selling effort and are not as basic to the disclosure system as a registration statement, the standards for liability and the burden of proof differ from those in the earlier provisions. Section 13.09 embodies the common law deceit standard, modified to exclude the element of intention, and places the initial burden of proof on the plaintiff. However, as in the preceding sections, once a plaintiff proves that a misrepresentation was knowingly or recklessly made, the burden shifts to the defendant to prove the availability of one of the

94 See section 13.07, Commentary.

* As is indicated by the phrase in square brackets in subsections (1), (3) and (4), two of the authors, Warren M.H. Grover and John L. Howard, believe that an action under this section should be available only at the instance of the Commission; see section 13.07, Commentary, for an explanation of their position.

specified defences.⁹⁵ In some circumstances the standard under the section may be less strict than at common law at which an action for negligent misrepresentation may be possible. For such cases the common law remedy is retained.⁹⁶

There may be some overlap between section 13.09 and sections 13.03 and 13.04. Section 13.09 is directed at false statements that are likely to affect the market price of a security regardless of whether the persons responsible for the misrepresentation trade. If the issuer or another insider does trade, liability may also be found under the earlier sections that limit damages on the basis of the violator's trading and impose a less stringent burden of proof on the plaintiff. If a violator's trading is direct, liability under section 13.03 will coexist with that under this section, and if the trades are impersonal, the plaintiff class is likely to be the same and the ceiling the higher of the amount under section 13.04 or under this section.⁹⁷

Although a block distribution circular relates to a selling effort and is treated as a prospectus for purposes of part 5, it is not so treated for liability purposes. A block distribution circular is required only when a large block of securities is sold into the market by a securityholder that does not control the issuer.⁹⁸ As the circular is prepared by a person not affiliated with the issuer, the selling securityholder is not likely to have complete access to information about the issuer's affairs. Moreover, a block distribution circular is directed primarily at market trading and is expected to contain information relating to the sale of the block of securities covered by it and to the market for the securities, including the impact of the sale in question.⁹⁹ A strict standard, like that applicable to a controlling securityholder under section 13.05, would therefore be too harsh. The Draft Act instead imposes the same standard of liability that applies to other market-oriented documents published by issuers and outsiders, that is, knowledge or recklessness.¹⁰⁰ And as a block distribution circular is directed at market trading, a selling securityholder is liable to any person who trades a security of a class covered by it.¹⁰¹

A prospectus and a takeover bid circular may give rise to liability under subsection (1) in a limited number of circumstances that are not covered by sections 13.05 and 13.06. Persons who buy

95 See subsections (5)–(7).

96 See subsection 13.16(2); and *see. e.g.* *Haig v. Bamford*, 72 D.L.R. (3d) 68 (S.C.C. 1976).

97 See section 13.07, Commentary.

98 See paragraph 2.17(d) and Commentary.

99 See section 5.01 and Commentary.

100 See subsection (3).

101 Cf. subsection 13.05(1) and Commentary.

a security of the issuer *not* covered by a prospectus or who *sell* a security of the issuer on the basis of the prospectus and persons who buy or sell a security of an *offeror* on the basis of a takeover bid circular are given a remedy in damages by subsection (2). Because the selling effort relating to a distribution or takeover bid is not directed at such persons, they do not receive the benefit of the lower standard and reverse onus of proof in the earlier sections but must meet the same standards as other plaintiffs who trade on the basis of a filed document. Sections 13.06, 13.08 and 13.09 thus provide a remedy for offerees in a takeover bid in all circumstances but one. Offerees who trade securities in the offeree corporation in the market on the basis of a misrepresentation in a takeover bid circular do not have a remedy under these provisions. If they suffer harm as a result of a false takeover bid circular they may obtain a remedy under section 13.12.

The relevant time for determining liability under subsection (1) is when the documents are filed unless they do not become available immediately upon filing. In the latter case the relevant time is when they are placed on the Commission's public file. The phrase "becomes available to the public" is used in subsection (1) in order to avoid the definition of "public" in section 2.31 which includes a dissemination period. As with the preceding provisions, section 13.09 does not impose a duty to correct documents that become misleading by reason of subsequent events. Rather it leaves the requirement to section 7.03 in relation to an issuer in order to enable the courts to devise remedies appropriate to the circumstances in light of the nature of the violation. It is expected, however, that the standard of liability for a failure to comply with section 7.03 will relate to the standard for the document that required correction. No similar requirement is applicable to a block distribution circular because the duty to amend a prospectus in section 5.12 does not apply to such a circular.¹⁰²

Finally, since the documents covered by section 13.09 may be published by an issuer as well as by individuals, the limitation on damages in subsection (8) is that applicable to a registration statement under subsection 13.07(5). The ceiling is available, however, only when a defendant's misrepresentation is made recklessly.

Section 13.10

Section 13.10 creates civil liability for manipulative conduct that affects the market price of securities of the class involved,

102 See section 5.12, Commentary.

that is, wash trading and other manipulation by trading. A plaintiff is presumed under the section to rely on the fair operation of the market so that proof of actual reliance on a violation is not required. It is difficult to conceive of a plaintiff being able to recover for such violations otherwise. Moreover, as the violations dealt with in this section are directed at the market price of a security, their impact is not dependent upon trading by a perpetrator so that it makes little sense to attempt to distinguish between direct and impersonal trading in connection with them.

Subsection (2) requires a plaintiff who trades more than a month after a violation to prove that the price at which he traded was affected by the defendant's manipulation. As after an interval of such length market forces are likely to have reasserted themselves, this requirement "is only fair".¹⁰³

An early version of this section, which followed the source provision more closely, included the conduct prohibited by paragraph 12.04(2)(a) (representations that an offer is "at the market" where no independent market exists) and subsection 12.04(3) (undertakings relating to the future value or price of a security). As such representations are most often made by a registrant to induce a particular client to trade, they are not included in section 13.10 but in section 13.14 which deals with improper conduct by registrants rather than manipulation. Even if a client's trade is impersonal the appropriate remedy is not one directed to the market but rather to the client under the later provision. And any such representations that are made publicly will likely constitute misrepresentations within subsection 13.09(4).

Because the practices with which the section deals necessitate a measure of damages somewhat different from the out-of-pocket measure that is expected to be applied under the other provisions of the Part, subsection (4) specifies an analogous measure appropriate to manipulative conduct. The measure is based upon the market value of the securities traded immediately preceding a defendant's manipulation so that a plaintiff will receive damages for the effects of the manipulation, less, of course, any amount that a defendant proves was not attributable to his violation. Where no market existed for the security prior to a manipulative scheme, a plaintiff would presumably prove his loss on the traditional out-of-pocket basis, the difference between the price he paid and the value he received. And as the prohibitions specified in subsection (1) involve knowledge or intent, there is no limitation on the amount of damages that may be recovered under them.¹⁰⁴

103 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, ss. 1408(a)-(c), Comment (1).

104 Cf. subsection 13.07(5) and Commentary.

The *ALI Code* includes a provision creating liability in favour of a person who is induced *not* to trade by manipulative conduct. However, as cases in which such a person can prove damages resulting from a violation are likely to be both rare and highly individual, the code requires a plaintiff to prove both his loss and that it was caused by the defendant's conduct.¹⁰⁵ The Draft Act, in accordance with the approach taken earlier in this Part, leaves to a court discretion to fashion a remedy in such circumstances pursuant to subsection 13.16(1).

Section 13.11

Section 13.11 provides remedies for a violation of the proxy provisions of the Draft Act and for a false proxy solicitation. It is necessarily broader than the preceding provisions in order to accommodate the context of a meeting of shareholders.¹⁰⁶ As correction and resolicitation are included in "compliance", there is no need to mention them expressly.

The coverage of the provision, however, extends beyond misrepresentations and technical violations and includes conduct in connection with a solicitation of proxies that is oppressive or unfairly prejudicial to securityholders. Although the recent "going private" phenomenon may be classified as either corporate or securities law, it clearly straddles both and has a serious impact on investors.¹⁰⁷ The inclusion of an oppression remedy in this section and in section 13.12 enables the Commission and the courts to deal with unfair squeeze outs that may have an adverse effect on investors and investor confidence. Under both sections, a plaintiff must prove that the conduct of the defendant is oppressive.

The section grants standing to sue not only to an issuer or a securityholder whose proxy is solicited but also to any other interested person. In an appropriate case a shareholder of a class that is affected by a meeting but that has no voting rights may bring an action; so may a director who holds no shares in the issuer. In short, standing under the section is to be interpreted broadly.

Paragraph (1)(d) expressly authorizes a court to award compensation for a loss that a plaintiff proves resulted from a violation in connection with a solicitation of proxies. Because a proxy circular is usually not intended as a sales document and is not a cornerstone of the disclosure scheme, damages may be awarded only to

105 See ALI FEDERAL SECURITIES CODE, s. 1710(e); see also e.g. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969).

106 See paragraphs (1)(a)–(c).

107 Cf. paragraph 3.01(e) and Commentary.

the extent that they are proved.¹⁰⁸ As a result there is no ceiling imposed on damages under the section.

In any event, the provision's primary purpose is not to provide an action for damages but rather to enable affected persons to rectify the results of a violation of the Draft Act. Persons who trade in the market on the basis of a misrepresentation in a proxy circular may have an action under subsection 13.09(4) (which does set a ceiling on damages), and those who trade in connection with the solicitation itself, for example, in a merger, may seek redress under section 13.03 if insider trading is involved. The standards and burdens of proof appropriate to such cases are established in the above provisions. Subsection (2), in an attempt to avoid unnecessary and confusing overlap, makes clear that the remedies available under them are exclusive.¹⁰⁹ But in other cases involving a proxy violation a plaintiff must prove both that the violation occurred and that it caused his damages.

Section 13.12

Section 13.12 provides remedies for a violation of the provisions of the Draft Act relating to takeover bids and creeping acquisitions insofar as they are not already available under previous sections. As a takeover bid includes an offer by an issuer to repurchase its own securities, the section includes an oppression remedy and thus grants the Commission and courts authority to deal with "going private" in all of its manifestations. The section parallels section 13.11 with the remedies modified as necessary for takeover bids and improper creeping acquisitions. It is expected that the courts will adopt a cautious approach to enjoining the voting of shares for a violation of the accelerated insider reporting requirements in section 7.13 similar to that under the Securities Exchange Act of 1934.¹¹⁰ However, the restrictive interpretation of standing to sue for damages under the 1934 act by the United States Supreme Court in *Piper v. Chris-Craft Industries, Inc.*¹¹¹ has been avoided; section 13.12 expressly grants standing to "an offeror or person who proposes to make a takeover bid". At the same time the section avoids the arguable excesses of the Court of

108 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1412, Comment (3); *In re Clinton Oil Company Securities Litigation*, Current, CCH FED. SEC. L. REP. ¶ 96,015 at 91,575 (D. Kan. 1977).

109 Cf. ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 1412, Note (4).

110 See e.g. *Rondeau v. Mosinee Paper Corporation*, 95 S. Ct. 2049 (1975).

111 97 S. Ct. 926 (1977).

Appeals decision in *Chris-Craft* by requiring a defeated offeror to prove both his loss and that the violation caused it.¹¹²

Apart from an action by an offeree securityholder based on oppression, a defeated offeror and an offeree corporation are the most likely plaintiffs in an action for damages under this section. Other persons who trade on the basis of a takeover bid circular must use the remedies provided in section 13.06 and subsection 13.09 (1), and offerees who trade or refrain from trading a security because of a directors' circular must sue under section 13.08.¹¹³ However, a person other than an offeree who trades a security of the offeree corporation in reliance on a false directors' circular may bring an action under this section to recover damages caused him by the circular.¹¹⁴ And the oppression remedy exists only under this section.¹¹⁵

The requirement that such a plaintiff proves his damages were caused by the circular is sufficient to bring this provision into line with the analogous remedies under section 13.09. In fact, it is arguable that this section imposes a greater burden on a plaintiff than the earlier one in that he must prove either actual reliance on the circular or that the circular had a direct impact on the price at which he traded. In short, like section 13.11, this section will most frequently provide a basis for relief other than damages.

Section 13.13

Section 13.13 provides a remedy for churning by a registrant of a client's account. The measure of damages derives from the *ALI Code*, s. 1717, which in turn is based on the case law relating to churning. Although the amount of commissions or profits and interest to be awarded is only that attributable to the trading that is "excessive", the defendant bears the burden of showing that it is less than the total amount paid by a plaintiff. If he cannot do so, the plaintiff recovers the total amount of commission and interest paid.¹¹⁶ Professor Loss suggests that additional items of damages under paragraph (c) "might include...transfer and capital gains taxes paid by the customer...income or capital appreciation, or both, that would have been yielded by the securities in the account on the date the violation began, and...trading losses caused by the

112 Cf. 480 F.2d 341 (2d Cir. 1973) (presumption of causation where violation).

113 See subsection (2); and see subsection 13.09(2) and Commentary.

114 See paragraph (1)(f).

115 See subsection (2) ("to the extent that he has an action").

116 See e.g. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 440 (N.D. Cal. 1968), affirmed, 430 F.2d 1202 (9th Cir. 1970).

violation".¹¹⁷ In fact paragraph (c) is intended to deal with "the unusual case".¹¹⁸ Nevertheless, as the principles relating to damages for churning are still in a developmental stage, the paragraph provides the flexibility necessary to fashion just results.¹¹⁹

Sections 13.14

Section 13.14 permits an action for rescission or damages against a person who violates the regulations relating to registrants' conflicts of interest, fails to fulfill a duty imposed on a registrant under part 11, sells short without declaring his short position, or makes a representation prohibited by section 12.04. Under the *ALI Code* the damages remedy is exclusive, while the provincial securities acts provide only a rescission remedy.¹²⁰ The rescission remedy has been retained in order to provide a deterrent to a violation of the specified provisions. A failure to send a confirmation contrary to section 11.06, for example, may not cause any loss to a customer and may not warrant disciplinary proceedings by the Commission. The threat of an action for rescission thus becomes the sanction that ensures compliance. The Draft Act therefore combines the approaches of the source provisions and retains both remedies. And any punitive element of the rescission remedy may be removed pursuant to subsection 13.02(4) which is incorporated into the provision by reference.¹²¹

The section does, however, alter the Canadian source provisions. The Ontario legislation contains a reverse onus that compels a registrant-defendant to prove he complied with its requirements and imposes a short (sixty-day) limitation period, whereas section 13.14 places the burden of proof on the plaintiff and extends the limitation period.¹²²

A few of the violations specified in section 13.14 are not readily susceptible of rescission. For example, hypothecation or lending of a customer's securities contrary to regulations under subsection 11.02(2) by their nature preclude the availability of rescission. A similar difficulty would exist if the Commission

117 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1410, Comment (1); *see also*, Leigh at n. 99 and following.

118 ALI FEDERAL SECURITIES CODE, s. 1717, Note.

119 *See generally* 6 L. LOSS at 3676-79; Brodsky, *Measuring Damages in Churning and Suitability Cases*, 6 SEC. REG. L.J. 157 (1978) (damage principles applied in churning cases by U.S. courts); and *see* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1410, Comment (2).

120 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 5, s. 915, Comment (1).

121 *See* subsection 13.02(4) and Commentary.

122 *See e.g.* Ontario Securities Act, 1978, s. 133(4); *cf.* Saskatchewan Securities Act, s. 152 (two-year limitation period).

adopts a regulation like Ontario Securities Act, 1978, s. 46.¹²³ (Nevertheless, the new Ontario act provides, in effect, a remedy in rescission or damages.) In such cases only the damage remedy in paragraph (b) will be available under the section. However, as common law remedies are retained by subsection 13.16(2), the section is not exclusive and damages based on a conversion measure are also available for such violations.¹²⁴

Finally, paragraph (a) adopts the meaning of rescission in section 13.02 rather than the extended meaning in subsection 13.01(2) because the violations specified do not involve any question of dissemination of information or risk of the market.¹²⁵ And in any event the rescission remedy in section 13.02 allows the courts the flexibility to soften any potentially harsh results.¹²⁶

Section 13.15

This section permits a person who intends to make a distribution to recover damages from an issuer or other person who fails to comply with an order of the Commission to supply the selling securityholder with information required to prepare a prospectus. Although the Commission may, under its general exempting power in section 3.03, waive some of the disclosure requirements and may bring an action under section 14.06 to enforce its order, the delays involved in a refusal by an issuer to provide the required information and the enforcement procedures may cause damage to a selling securityholder. In these circumstances the securityholder is entitled to recover damages for any loss that he can prove is caused by the issuer's refusal. It was suggested that the section be altered so that an issuer would be liable only for failure to comply "within a reasonable time" with an order of the Commission but the suggestion was not adopted. As the Commission will likely specify time periods in any order made under section 5.07, the inclusion of such a condition in this section would be superfluous and would merely provide an unnecessary obstacle to a complaining securityholder.

Section 13.16

Although the types of actions that are likely to be brought most frequently are expressly dealt with in sections 13.02 to 13.15, it is inevitable that violations of provisions of the Draft Act will

123 See subsection 11.02(1), Commentary.

124 See *e.g.* *Solloway v. McLaughlin*, [1938] A.C. 247 (P.C. 1937).

125 See subsection 13.01(2), Commentary.

126 See subsection 13.02(4).

occur which should not go without a remedy but for which no civil liability is expressly provided. For example, a failure of a self-regulatory organization to observe the requirements of the Draft Act may result in harm to an investor, as may a failure to file insider reports.¹²⁷ Indeed an attempt to devise an exhaustive scheme of civil liability would be at least as difficult a task as cataloguing the varieties of fraud.¹²⁸ However, Canadian and other Commonwealth courts have generally been reluctant, except in relation to safety and highway legislation, to imply a cause of action from the violation of legislation.¹²⁹ Subsection (1) therefore expressly authorizes them to do so for a violation of the Draft Act that is not otherwise dealt with in this Part and also for the violation of a self-regulatory by-law.¹³⁰ Section 13.16 thus serves as a backstop for matters which are too difficult or concerning which actions arise too infrequently to be dealt with expressly.

In such areas the judicial development of remedies in the common law tradition is essential so that the courts may deal with questions as they arise, on a case-by-case basis. Liability for a failure to register under part 8, for example, is not susceptible of a single solution and the difficulties of definition and limitation have been left for the courts to deal with in concrete cases.¹³¹ Similarly, civil remedies for a failure to comply with the duty in section 7.03 to make timely disclosure have been left to judicial implication in light of the standards imposed on filed documents the accuracy of which is affected by new material developments.¹³² Presumably the courts will not imply an action where there is compliance with the section by filing a confidential notice.¹³³

More important, the development of remedies for deceptive conduct that violates section 12.01 but is not expressly dealt with in part 13 is left to the judiciary. It is expected that in treating such matters the courts will have regard to the provisions of this Part most closely analogous to the violation involved and will as cases arise refine the standards for liability for deception.¹³⁴ For example, the courts may grant a remedy to a person who is induced not

127 See e.g. *Grow Chemical Corp. v. Uran*, 316 F. Supp. 891 (S.D.N.Y. 1970) (insider reports); *Baird v. Franklin*, 141 F.2d 238 (2d Cir. 1944), *cert. denied*, 323 U.S. 737 (securities exchange); and see, *Leigh*, ch. I.B.13.

128 See section 12.01, Commentary.

129 See e.g. *Orpen v. Roberts*, [1925] S.C.R. 364; *Direct Lumber Co. Ltd. v. Western Plywood Co. Ltd.*, 35 D.L.R. (2d) 1 (S.C.C. 1962).

130 See, *Leigh*, chs. I.B.13, 14.

131 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1401(a), Comment (5); Tent. Draft No. 5, s. 1417(a), Comment (2).

132 See e.g. sections 13.07-13.09 and Commentary.

133 See subsection 7.03(2) and Commentary.

134 See sections 2.15, 12.01 and Commentary.

to trade by a violation of section 12.01.¹³⁵ And the difficult issues involved in directors' liability to their corporation for fraud in connection with a securities transaction are left to them as well.

The power to imply a cause of action for the violation of a by-law of a self-regulatory organization is somewhat novel in Canada, but in light of the scheme of the Draft Act it is a useful supplement to the other provisions relating to the conduct of registrants. Part 9 requires the registration of self-regulatory organizations and delegates to such registrants primary supervisory authority over market actors, not only in respect of standards of admission but also in respect of continued compliance with the organization's by-laws and the capital requirements under part 8.¹³⁶ The Commission may also delegate to them the administration and enforcement of various provisions of the Draft Act itself and may refrain from adopting regulations in light of the by-laws of a registered self-regulatory body.¹³⁷ In short, under the Draft Act registered self-regulatory organizations perform public functions and their by-laws are not substantially different from regulations under other statutes. As subsection (1) mandates the courts to imply actions for a violation of the Draft Act or the regulations enacted pursuant to it, it is only a small step to extend the mandate to include self-regulatory by-laws, especially in light of the fact that the courts have long given recognition to stock exchange rules as defining the "custom of the trade". The courts in the United States have implied actions for some time for a violation of a self-regulatory by-law and have developed standards to govern such implication.¹³⁸

Subsection 13.16(1) attempts to provide guidelines for the exercise by the courts of the power granted to imply actions. An implied action must be consistent with analogous actions that are expressly created in part 13.¹³⁹ A court should, therefore, when applying the section, impose the standards of liability and burdens of proof in the most closely analogous provision of this Part and, in actions based on impersonal trading as under section 13.04, or based on conduct affecting the market price of a security as under sections 13.07 to 13.10, should impose limitations on damages

135 See e.g. *U.S. v. Ashdown*, 509 F.2d 793, 799-800 (5th Cir. 1975) (annual report sent to "lull" investors "into false sense of security" so that they would retain shares); *Elderkin v. Merrill Lynch, Royal Securities Limited*, 22 N.S.R. (2d) 218, 232-34 (App. Div. 1977); cf. section 13.10, Commentary; but see ALI FEDERAL SECURITIES CODE, s. 1722(b).

136 See part 9 and Commentary, *passim*.

137 See section 9.05.

138 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1416, Comments (1)-(3) (standards applied by courts); and see, *Leigh*, ch. I.B.13.

139 See paragraph (1)(a).

similar to those specified for analogous cases. In fact, paragraph (1)(a) makes the latter requirement express. Nevertheless, the courts are given sufficient flexibility to fashion appropriate standards for novel cases. In an action by a person who refrained from trading, for example, it is open to a court to define the burden on the plaintiff to prove that he suffered a loss as a result of the violation in question without regard to the presumptions in the preceding sections. It was for this reason that such actions were left to section 13.16.¹⁴⁰

Paragraph (1)(b) incorporates the essential elements for the implication of a private cause of action at common law.¹⁴¹ But it too is not intended to be exhaustive. Although the factors specified in subsection (1) are necessary conditions for the implication of a cause of action, it is expected that a number of other factors will be considered. The courts, for example, are likely to take into account the effect of implied liability in relation to the seriousness of the violation in question and to satisfy themselves that the implication of a cause of action would not, in the circumstances of a particular case or in relation to a provision of the Draft Act, be disproportionate to the violation alleged. Thus an action that creates the possibility of substantial liability for a late filing or some other minor violation for which the statutory penalties and enforcement mechanisms provide an adequate deterrent is not likely to be permitted.¹⁴²

Similar considerations may take on special importance and provide greater difficulties of application in the context of by-laws enacted by a self-regulatory organization, for in such cases the likely deterrent effect of an implied action on the performance by the self-regulatory organization of its statutory functions must also be considered. However, it is expected that the Commission will in such cases make use of the power in section 14.08 to appear as a friend of the court so that the court may have the benefit of the expertise developed by the Commission in administering part 9 of the Draft Act. A court may consider, as well, whether a particular by-law is parallel to the common law or to a rule of the Commission, although this factor may cut both ways, or whether the by-law was adopted or amended as a result of a Commission order. And by-laws supplementing the Draft Act by specifying limits for general prohibitions in the statute may provide standards for judicial application.¹⁴³

140 See section 13.10, Commentary.

141 See e.g. *Leigh*, ch. I.B.14.

142 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1423(a), Comment (4); ALI FEDERAL SECURITIES CODE, s. 1722(a); and cf. *Leigh* at nn. 119–20.

143 Cf. ALI FEDERAL SECURITIES CODE, s. 1721, Note (5).

Subsection (2) makes clear that the remedies in part 13 are in addition to those available at common law. The section thus ensures that the courts retain the flexibility to apply common law standards in actions based on securities trading and removes the need that would otherwise exist to specify in this Part all the remedies and defences available under the Draft Act. For example, section 1709(a) of the *ALI Code* creates liability for fraudulent conduct by persons acting in a fiduciary capacity. The section specifies a deceit standard in order “to preclude the possibility of *implied* liability...for a violation...by means of a negligent or even wholly innocent misrepresentation”.¹⁴⁴ As a result, it imposes a less stringent standard than the common law. It is trite law that a person is liable for negligent misrepresentation to a person to whom he owes a fiduciary obligation.¹⁴⁵ Similarly at common law a client of a broker or dealer may have more easily obtainable remedies in contract.¹⁴⁶ Because subsection (2) makes clear that common law remedies continue, a similar section is neither necessary nor included in part 13. In fact, it is expected that common law fiduciary standards will also influence the courts in the application of subsection (1).

The *ALI Code* contains a number of other provisions derived from experience under the U.S. securities laws which involve the application of common law principles. For example, the code prohibits punitive or exemplary damages and damages for emotional distress (s. 1723(b)), permits and establishes standards for the defences of unclean hands and *in pari delicto* (s. 1725(d)) and precludes a defence of laches in an action for damages (s. 1727(h)). It also establishes standards for enforcement of contracts that involve a violation of its provisions, for indemnification of persons who violate its provisions and for the validity of waivers of its requirements; and it provides as well for the enforcement of rights acquired in securities that are improperly loaned or hypothecated.¹⁴⁷ A provision of the code permitting consequential damages was considered in connection with an early version of the Draft Act.¹⁴⁸ It was not included, however, as the courts have recently indicated a willingness to extend the out-of-pocket measure of damages to include consequential damages.¹⁴⁹ The Draft Act per-

144 ALI FEDERAL SECURITIES CODE, s. 1709, Note (1).

145 See e.g. *Nocton v. Lord Ashburton*, [1914] A.C. 932 (H.L.).

146 See e.g. *Moody v. Cox*, [1917] 2 Ch. 71 (C.A.) (rescission available for failure by fiduciary to disclose material facts); *Laskin v. Bache & Co., Inc.*, 23 D.L.R. (3d) 385 (Ont. C.A. 1971); *Elderkin v. Merrill Lynch, Royal Securities Limited*, 22 N.S.R. (2d) 218 (App. Div. 1977).

147 See ALI FEDERAL SECURITIES CODE, ss. 1722(c)-(d), 1724(e), 1725.

148 See *id.* s. 1723(a).

149 See e.g. *Doyle v. Olby (Ironmongers) Ltd.*, [1969] 2 Q.B. 158(C.A.); *Wandinger v. Lake*, 2 Bus. L.R. 39 (Ont. H.C. 1977); and see generally, *Anisman* at 249 n. 548.

mits them the flexibility to do so not only in relation to this matter but in respect of all of the matters mentioned above. They may thus adapt common law principles to the context of the Draft Act.

Section 13.17

The preparation and dissemination of disclosure documents may involve a substantial number of people with different degrees of responsibility for the contents, ranging from primary responsibility to virtually none. Similarly, trading in securities for any purpose, whether it be the furtherance of a manipulative scheme or the making and processing of a transaction for a client, is likely to require the efforts of several persons, again with varying degrees of involvement. It is necessary, therefore, to prescribe the liability of persons who, although not the principal perpetrators of a violation of the Draft Act, facilitate its occurrence in a subsidiary but culpable manner, and section 13.17 does so.

Subsection (1) makes aiders and abettors liable to the same extent as a principal violator. It thus applies to any person who participates in a violation to a substantial degree. A person who "gives substantial assistance" is included in the provision in order to catch persons who aid a violation but provide no motivating element of it.¹⁵⁰ Although there is some controversy in the United States concerning the application of the phrase to persons who take no affirmative action,¹⁵¹ the requirements that the assistance be substantial and that the person giving it know of the conduct constituting a violation of the Draft Act are sufficient to ensure that only persons who are culpable will be held liable under the section.¹⁵² In fact, the standard in the section is less strict than the boilerplate provision in federal statutes concerning the criminal liability of directors and officers for conduct of their corporation.¹⁵³ Even knowing acquiescence is not a sufficient basis for liability under section 13.17 unless, possibly, a duty to take action exists (and in the latter case breach of the duty would likely constitute the director a primary violator).¹⁵⁴ Nevertheless, the

150 See e.g. *Anderson v. F.I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968) (securities firm permitted non-employee to use offices and telephones to deal with clients in connection with fraudulent scheme).

151 See e.g. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 641-44 (1972); Note, *The Private Action against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct*, 29 VAND. L. REV. 1233 (1976).

152 Cf. *Stern v. American Bankshares Corporation*, 429 F. Supp. 818, 825-27 (E.D. Wis. 1977).

153 Cf. Canada Business Corporations Act, s. 243(2).

154 Cf. Ruder, *supra* note 151, at 644.

intent of the subsection is that knowledge of facts constituting a violation be sufficient to satisfy its requirements.¹⁵⁵

The final clause of subsection (1) ensures that an aider and abetter is treated like any other defendant under the Draft Act by making clear that where there is more than one principal violator, the aider and abetter is not liable for more than the maximum amount of damages under this Part. Thus if two principals are each liable for \$100,000, the applicable ceiling, the aider and abetter is liable for the same amount and not \$200,000.

Subsection (2) imposes secondary liability on registrants for a failure to supervise adequately persons acting under their control. The provision is necessary to supplement the common law which does not impose the equivalent of a duty to supervise. As a result, cases may arise in which the special nature of a securities transaction precludes the application of the common law principles of vicarious liability in accordance with which an employer may otherwise be held liable for the tortious acts of an employee acting within the scope of his employment and for contractual obligations of his agent acting with ostensible authority.¹⁵⁶ Moreover, as subsection (1) requires knowledge of the conduct that constitutes a violation, it too is insufficient to impose a duty to supervise. Subsection (2) is therefore included to ensure that registrants take reasonable care to supervise the activities of their employees. Paragraph (2)(b), in effect, imposes a duty on securities firms to establish reasonable supervisory structures and to enforce them.¹⁵⁷

Section 13.18

Section 13.18 deals with liability that results from the conduct of more than one person. Subsection (1) makes clear that all such liability is joint and several whether the violation of the Draft Act is characterized as contractual or tortious.¹⁵⁸ The provision is especially important in relation to activities undertaken in concert that involve a number of people. Thus, as the Ontario source provision indicates, it is essential in relation to distributions and prospectus liability.¹⁵⁹ It is also of substantial importance in rela-

155 *Cf. Selangor United Rubber Estates Ltd. v. Cradock (No. 3)*, [1968] 1 W.L.R. 1555, 1590 (Ch.).

156 *See e.g. Hazlewood v. West Coast Securities Ltd.*, 49 D.L.R. (3d) 46 (B.C.S.C. 1974); *cf. Ruder, supra* note 151, at 604-05.

157 *Cf. Notice, B.C. Corporate, Financial and Regulatory Services Weekly Summary*, January 6, 1978, at 3 (December 22, 1977).

158 *See generally J. FLEMING, THE LAW OF TORTS* 237-41 (5th ed. 1977); G. FRIDMAN, *THE LAW OF CONTRACT IN CANADA* 405-07 (1976).

159 *Cf. section 13.05.*

tion to other provisions of this Part that involve, for example, insider trading by tippees (sections 13.03 and 13.04), takeover bids, directors' circulars and other public filings and statements (sections 13.06–13.09, 13.11–13.12), manipulative conduct (section 13.10), and aiding and abetting (section 13.17).

Subsection (2) authorizes a court to award contribution where the conduct of more than one person gives rise to the same liability under the Draft Act and establishes minimum standards for doing so. Although at common law contribution among joint tortfeasors was not permitted, the common law rule was long ago reversed throughout the Commonwealth.¹⁶⁰ Ironically, although contribution for harm arising out of a contractual relationship was authorized at common law, the contribution legislation in the Commonwealth has been interpreted to exclude actions based on contract even where they might have been characterized as tortious.¹⁶¹ The Draft Act applies equally to torts and contracts that give rise to liability under it.¹⁶² (The source provision in the *ALI Code* is based on the English Law Reform (Married Woman and Tortfeasors) Act, 1935,¹⁶³ which has been adopted in several provinces.¹⁶⁴)

Subsection (2) attempts to avoid another difficulty encountered under the English and early Canadian legislation by referring to a violation for which a person "is or, if sued, would have been liable" in order to include all conduct that creates liability under the Draft Act whether or not it has been the subject of an action against a particular defendant, thus avoiding the questions of when a person "is liable" that have arisen under earlier legislation.¹⁶⁵ The subsection also permits a joint violator to be joined as a third party or to be sued by a person who has already been found liable under the Part.¹⁶⁶

Subsection (2) and all its source provisions, direct and indirect, grant a court the flexibility to reach just results in actions

160 See e.g. J. FLEMING, *supra* note 158, at 241–50; C. WRIGHT, *CASES ON THE LAW OF TORTS* 388–94 (4th ed. 1967).

161 See e.g. S. WILLISTON, 2 *A TREATISE ON THE LAW OF CONTRACTS*, section 345 at 762–65 (3d ed. by W. Jaeger 1959); J. FLEMING, *supra* note 158, at 243.

162 See e.g. Weinrib, *Contribution in a Contractual Setting*, 54 *CAN. B. REV.* 338 (1976); cf. the discussion of similar but more limited provisions in corporate and securities legislation in F. WEGENAST, *THE LAW OF CANADIAN COMPANIES* 728 (1931) (Canada Companies Act); Douglas & Bates, *The Federal Securities Act of 1933*, 43 *YALE L.J.* 171 (1933).

163 25 & 26 Geo. 5, c. 30, s. 6.

164 See *ALI FEDERAL SECURITIES CODE*, Tent. Draft No. 2, s. 1418(f), Comment (2); C. WRIGHT, *supra* note 160, at 388.

165 See e.g. J. FLEMING, *supra* note 158, at 242–46; see also Negligence Act, R.S.O. 1970, c. 296, s. 3.

166 Cf. G. WATSON & N. WILLIAMS, *CANADIAN CIVIL PROCEDURE: CASES AND MATERIALS* 7–44 (2d ed. 1977).

involving contribution in light of the relative responsibility of the persons who committed the violation for the damages suffered.¹⁶⁷ The Ontario Negligence Act, s. 2(1), is phrased in terms of "degrees of fault"; the Draft Act follows the source provision and uses the wider phrase "relative responsibility" to permit consideration of separate agreements made by defendants to apportion damages among them, for example, among underwriters in a distribution.¹⁶⁸ Thus a decision allocating contribution among participating violators on a *pro rata* basis is likely to occur only if they are equally responsible for the damages resulting from their conduct or if they have so agreed.¹⁶⁹

Section 13.19

Section 13.19 specifies the limitation periods for an action under the Draft Act in order to avoid the establishment of different periods in the various jurisdictions in which an action may be brought and so to preclude forum shopping. The section ensures that like cases will be treated alike under the Draft Act wherever they occur and avoids the ambiguities that might arise under some of the provincial limitation acts.¹⁷⁰

As Professor Loss states, there is "no perfect solution" to the question of the appropriate limitation periods for actions in this area.¹⁷¹ Section 13.19 deals in one place with all actions possible under the Draft Act and establishes four basic limitation periods. The period for a violation that gives rise to a rescission remedy incorporating a fungibility concept but not a duty of mitigation is six months from the time of the violation. The short period derives from the new Ontario act and is applicable only to the rescission remedy as defined in section 13.02. It is intended to deny a windfall profit to a plaintiff who holds for a long period or who because of the fungibility concept sells and repurchases the security after the price falls.¹⁷² Other rescission remedies, because of the market notion in subsection 13.01(2), have the same limitation period as an action for damages for the same violation.

167 Cf. J. FLEMING, *supra* note 158, at 246-47.

168 Cf. ALI FEDERAL SECURITIES CODE, s. 1724(f)(1).

169 Cf. Ruder, *supra* note 151, at 650-51; Note, *The Role of Contribution in Determining Underwriters' Liability under Section 11 of the Securities Act of 1933*, 63 VA. L. REV. 79 (1977).

170 See e.g. *Anisman* at 266 n. 665; cf. ONTARIO, MINISTRY OF THE ATTORNEY GENERAL, DISCUSSION PAPER ON PROPOSED LIMITATIONS ACT 20-22 (September 1977) (Discussion Draft of Proposed Act, s. 18, would not repeal "special" limitation provisions of Ontario Securities Act).

171 ALI FEDERAL SECURITIES CODE, s. 1727, Note (1).

172 Cf. Ontario Securities Act, 1978, s. 135(a).

The period for a technical offence where a plaintiff knows that a cause of action exists is two years from the time of the violation, including an action for damages under section 13.02.¹⁷³ For other violations it is two years from the time when the plaintiff learns of the facts constituting a cause of action. And in any event there is a maximum period of six years from the time when the cause of action arises.¹⁷⁴

The limitations are thus both broader and narrower than those in the Canadian source provisions. The provincial securities acts impose a sixty-day limitation period on an action for rescission of a transaction in which a registrant fails to disclose his interest.¹⁷⁵ The only other limitation period specified in the provincial acts relates to insider trading for which the period is two years after the completion of the transaction giving rise to the cause of action. The Canada Business Corporations Act, s. 125(6), originally provided the same period or a period of two years after the insider's transaction was reported, whichever was later, but has been amended so that the period now is two years after the time at which the insider's transaction is reported for public corporations and two years after the facts giving rise to the action are discovered for a corporation that is not public. And the Ontario Securities Act, 1978, provides a period of 180 days for rescission in connection with a false prospectus, and for any other action extends the application of the period to all liability and increases it to three years from the date of the transaction or six months from the date on which the plaintiff learns of the facts giving rise to his cause of action whichever occurs first.

The Draft Act attempts a compromise solution by extending the limitation periods provided at present under the provincial securities legislation and imposing a limit regardless of a plaintiff's knowledge of the cause of action. The section thus adopts two- and six-year limitation periods. The six-year period is the same as that for fraud under the provincial limitations acts.¹⁷⁶ (The periods do not follow any of the source provisions; the *ALI Code* initially specified two- and four-year periods but was subsequently revised to provide one- and five-year periods.¹⁷⁷)

An action not expressly mentioned in subsections (1) to (8) is subject to the limitation period specified for the action most closely analogous to it. Subsection (9) is necessary because several sections

173 See subsection (2).

174 See subsections (3)-(8).

175 See e.g. Ontario Securities Act, s. 71(1); cf. Ontario Bill 30, s. 133(5) (90 days).

176 See e.g. R.S.O. 1970, c. 246, s. 45(1)(g).

177 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, ss. 1421(a)-(e); ALI FEDERAL SECURITIES CODE, s. 1727.

in part 13 impose liability for the types of violation in both subsections (2) and (3), for example, sections 13.11 and 13.12 which deal with proxy solicitation and takeover bids, and section 13.14 which provides damages as well as rescission for improper market conduct and for a failure to deliver a prospectus contrary to subsection 5.04(1). Implied actions under section 13.16 must, of course, be treated in the same manner.

Section 13.20

Section 13.20 authorizes a person who buys or sells in a direct transaction in violation of the Draft Act to make a rescission offer to persons with whom he traded in order to determine the extent of his liability under this Part as of a specific time. The section is similar to provisions "fairly common" in state securities acts and embodies, in effect, a principle of mitigation similar to that implicit in the remedies provided in the preceding sections.¹⁷⁸ In utilizing the section a potential defendant forces a settlement but in return assumes liability and foregoes the defences available under the Draft Act.¹⁷⁹

The section makes clear that a rescission offer is available only where privity of contract exists between the parties to a transaction. The limitation to privity situations enables a violator "to make the same offer to all persons similarly situated" and precludes him from "buying out those who are most likely to sue and hope for the rest" to take no action.¹⁸⁰

A rescission offer, like a takeover bid or proxy circular, must be in writing, must contain information prescribed in regulations and must be filed with the Commission when it is sent to the offerees.¹⁸¹ It is expected that the Commission will require the offer to include information describing its terms, arrangements made by the offeror to fulfill them, the violation to which the offer relates and any financial or other information it thinks material to offerees.¹⁸² The thirty-five-day period specified in paragraphs (1)(c) and (2)(c) ensures that offerees have adequate time to digest the information and decide whether to accept a rescission offer. No provision relating to a misrepresentation in a rescission offer is included in this section as such conduct would fall within section

178 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1421(f)(1)-(5), Comment (1).

179 For a comprehensive and illuminating discussion of rescission offers by sellers of securities, see Bromberg, *Curing Securities Violations: Rescission Offers and Other Techniques*, 1 J. CORP. L. 1 (1975).

180 ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1421(f)(1)-(5), Comment (2).

181 See subsection (3).

182 Cf. e.g. Texas Securities Act, ss. 33I, 33J, 3 CCH BLUE SKY L. REP. ¶ 46,133 (Laws 1957, c. 269 as amended 1977, S.B. No. 469).

12.01, or possibly 13.03, and could form the basis of a further action by the offerees.

A rescission offer by a seller for over 10% of the outstanding equity securities of an issuer would be a "takeover bid" within section 7.19 and, similarly, an offer by a control person who has purchased might constitute a distribution subject to part 5 of the Draft Act.¹⁸³ However, the protection of parts 5 and 7 is unnecessary in a rescission offer, especially in light of the Commission's powers under subsection (3). Subsection (5) therefore excludes a rescission offer from the earlier Parts.¹⁸⁴

It has been suggested that the policy of this section be extended to include "settlement offers" based on the difference between the price at which a security was traded by the violator and the market price of the security during a specified period of time before the offer.¹⁸⁵ If this suggestion were adopted the technique might be made applicable to impersonal as well as direct trades but substantial refinement would be necessary to specify appropriate procedures and standards, including disclosure standards. Nevertheless, it might be advisable to give the Commission the power to permit and establish procedures for "settlement offers" by regulation.

183 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1421(f)(6) and Comment.

184 Cf. Bromberg, *supra* note 179, at 50 n. 294.

185 See *id.* at 52.

Provisions of Part 13

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.01(1)	definition	“direct and impersonal trades”			
13.01(2)	definition				
13.02(1)	sale in distribution before prospectus accepted	direct	any person who purchases security in distribution	issuer, selling security-holder, underwriter	strict
13.02(2)	sale in distribution before prospectus accepted	direct	direct purchaser	registrant (other than underwriter)	strict
13.03(1)	insider trading	direct	purchaser or seller	“insider” (including “tippee”) who trades	knowledge of confidential information
13.03(2)	tipping	direct	purchaser or seller	“insider” who tips	knowledge of confidential information

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
		“rescission”		
plaintiff to prove violation and trade		rescission or damages		
plaintiff to prove violation and trade		rescission or damages		
plaintiff to prove violation; defendant to prove defences	(a) plaintiff knew or should have known confidential information; (b) <i>cf.</i> defences in subsection 12.02(4)	(a) rescission or damages; (b) accounting for benefits by primary insider		
plaintiff to prove violation; defendant to prove defences	(a) plaintiff knew or should have known confidential information; (b) <i>cf.</i> defences in subsection 12.02(4)	(a) damages; (b) accounting		

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.04	insider trading and tipping	impersonal	purchaser or seller of same class of security between day when insider or tippee trades and day material facts become public	“insider” (including “tippee”) who trades and “insider” who tips	knowledge of confidential information
13.05(1)	false prospectus: (a) misrepresentation or omission; (b) failure to amend	direct	any purchaser in distribution	1. issuer; 2. selling security-holder; 3. lead underwriter	strict for issuer; defences based on due diligence and no negligence for others

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove violation; defendant to prove defences	(a) plaintiff knew or should have known confidential information; (b) <i>cf.</i> defences in subsection 12.02(4); (c) damages reduced to extent loss not caused by violation ("comparative causation" defence)	(a) damages; (b) accounting as under s. 13.03		twice amount of damages if trade were direct
plaintiff to prove false prospectus; defendant to prove defences	(a) plaintiff knew truth; (b) correction of prospectus before plaintiff bought or relied; (c) no knowledge and no negligence concerning subsequent event necessitating correction (not available to issuer); (d) resignation and notification before prospectus accepted	rescission or damages		underwriter liable only for portion underwritten by him

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.05(2)	false prospectus: (a) misrepresentation or omission; (b) failure to amend	direct	any purchaser in distribution	1. director; 2. prospective director; 3. principal officers; 4. expert	due diligence or no negligence

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove false prospectus; defendant to prove defences	(e) resignation and notification on becoming aware of prospectus acceptance; (f) reasonable belief, after reasonable investigation, in truth (not available to issuer or selling security-holder); (g) reasonable belief in truth of expert's statement (not available to issuer or selling security-holder); (h) expert's extract not accurately reproduced and notification when learned of it; (i) issuer may use defences in (f) and (g) re information about unrelated issuer;	damages		

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.06(1)	false take-over bid circular: (a) misrepresentation or omission; (b) failure to amend	direct	accepting offeree	offeror	strict
13.06(2)	false take-over bid circular: (a) misrepresentation or omission; (b) failure to amend	direct	accepting offeree	1. dealer-manager; 2. director; 3. prospective director; 4. principal officers; 5. expert	due diligence or no negligence

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
	(j) issuer may use all defences where secondary distribution; (k) selling securityholder may use defence in (f) re information derived from issuer's reports			
plaintiff to prove false takeover bid circular; defendant to prove defences	defences available under section 13.05 to issuer and selling securityholder; where correction, must be reasonable right of offerees to withdraw	rescission or damages		
plaintiff to prove false circular; defendant to prove defences	defences available to equivalent person under section 13.05; where correction, must be reasonable right of offerees to withdraw	damages		

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.07	false registration statement: misrepresentation or omission	direct and impersonal	person who trades after filing	issuer	due diligence or no negligence; knowing misrepresentation negates ceiling

13.08	false directors' circular: misrepresentation or omission	direct and impersonal or failure to trade	offerees who trade or refrain from accepting bid	1. offeree director; 2. others who sign circular	due diligence or no negligence; knowing misrepresentation negates ceiling
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Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove false statement; defendant to prove defences; plaintiff must prove knowledge to overcome ceiling	(a) plaintiff knew or should have known truth; (b) correction of statement before plaintiff traded; (c) no knowledge and no negligence concerning need for correction; (d) defences (f) and (g) under section 13.05; (e) "comparative causation" defence	damages		greatest of: (a) \$100,000; (b) 1%, up to \$1,000,000 of gross revenues; (c) defendant's trading profit
plaintiff to prove false statement; defendant to prove defences; plaintiff must prove knowledge to overcome ceiling	(a) defences (a), (b), (c) and (e) under section 13.07; (b) defences (d), (e), (f), (g) and (h) under section 13.05; (c) indicates disagreement with misrepresentation and states truth in directors' circular	damages		greater of: (a) \$100,000; (b) defendant's trading profit

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.09(1)	false 1. annual report; 2. quarterly report; 3. press release; 4. takeover bid circular; 5. prospectus: misrepresentation or omission	direct and impersonal	(a) re 1, 2 and 3, person who trades security of issuer after report public; (b) re 4 and 5, person who purchases or sells security of issuer or offeror other than security covered by filing	issuer	knowledge or recklessness
13.09(3)	false block distribution circular: misrepresentation or omission	direct and impersonal	person who purchases security of class covered by circular	selling security-holder	knowledge or recklessness
13.09(4)	false 1. proxy circular; 2. press releases: misrepresentation or omission	direct and impersonal	person who after violation trades security of issuer to which release relates	person who violates ss. 12.01 (b) or (e) by means of misrepresentation	knowledge or recklessness
13.10	manipulation: wash trading and by trading	direct and impersonal	person who trades security of class after violation	person who engages in wash trading or other manipulation by trading	standards in substantive offence; generally knowledge implicit but specific intent required for manipulation by trading

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove knowing or reckless conduct; defendant to prove defences	(a) plaintiff knew truth; (b) correction of filing before plaintiff traded; (c) "comparative causation" defence	damages		same as section 13.07
plaintiff to prove knowing or reckless conduct; defendant to prove defences	(a) plaintiff knew truth; (b) correction before plaintiff traded; (c) "comparative causation" defence	damages		same as section 13.07
plaintiff to prove knowing or reckless conduct; defendant to prove defences	(a) plaintiff knew truth; (b) correction before plaintiff traded; (c) "comparative causation" defence	damages		same as section 13.07
plaintiff to prove violation; if traded more than 30 days after violation must also prove price affected by violation; defendant to prove defences	(a) plaintiff knew of violation; (b) "comparative causation" defence	damages		

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.11	1. violation of proxy provisions; 2. deception in connection with proxy circular; 3. oppression of security-holders in connection with proxy solicitation	none necessary	1. issuer; 2. security-holder of class to which solicitation relates; 3. interested person but not (for damages) person who has action under section 13.03 or 13.09	person who violates s. 7.05, 7.09 or 12.01(b) or who engages in conduct oppressive to security-holders	standards in substantive provision; oppression
13.12	1. violation of accelerated insider reporting requirement; 2. violation of takeover bid provisions; 3. deception in connection with takeover bid; 4. oppression of security-holders in connection with takeover bid	none necessary	1. issuer (re reporting); 2. offeree issuer; 3. offeree; 4. other security-holder of offeree issuer; 5. offeror; 6. interested person but not (for damages) person who has action under s. 13.06, 13.08 or 13.09(1)	person who violates ss. 7.13, 7.20 to 7.25 or 12.01 (c) or who engages in conduct oppressive to security-holders	in substantive provisions; oppression
13.13	churning		customer	person who churns	in substantive provision

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove violation or oppression and (re damages) loss caused by it		1. restrain- ing order; 2. compliance order; 3. set aside action taken; 4. damages		
plaintiff to prove violation or oppression and (re damages) loss caused by it		1. restrain- ing order; 2. compliance order; 3. variation of time periods for takeover bid; 4. divesti- ture; 5. set aside action taken; 6. damages		
plaintiff to prove violation; defendant to prove dam- ages less than maximum attributable to trading (see Commentary)		damages	registrant's (a) commis- sion or profit, (b) interest paid by cus- tomer, and (c) additional damages as court thinks fit, i.e., con- sequential damages	

Section	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
13.14	improper market conduct including violation of: (a) prospectus delivery requirement; (b) regulations re market-making, conflict of interest or hypothecation and lending; (c) requirements re confirmation, suitability rules; (d) regulations re short selling; (e) prohibition against specified representations	direct and impersonal	1. person with whom violator trades; 2. customer	person who commits violation	in substantive provision
13.15	failure to comply with Commission order to provide information to selling security-holder for prospectus		secondary distributor	issuer	in substantive provision
13.16(1)	violation of Act, regulation or by-law for which liability not expressly provided		member of class intended to be protected	person who commits violation	in substantive provision

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove violation and loss caused by it		rescission or damages		
plaintiff to prove failure to comply and loss caused by it		damages		
plaintiff to prove violation, loss caused by it and that action should be implied		rescission or damages		as court considers appropriate in light of analogous provisions

n	Nature of violation	Nature of trade	Plaintiffs	Persons liable	Standard for liability
2)	remedies at common law and equity continued				
1)	secondary liability			aider and abetter	knowledge of violation or breach of duty
2)	secondary liability			registrant who controls primary violator	no negligence
1)	liability joint and several				
(2)	contribution		violator who pays damages or settles	other violators	relative responsibility of violators
	limitation periods				
	rescission offer				

Burden of proof	Defences	Remedies	Measure of damages	Ceiling on liability
plaintiff to prove violation and aiding and abetting		damages		same ceiling for each defendant
plaintiff to prove violation and control; defendant to prove defences	(a) no control at time of violation; (b) no knowledge and no negligence re violation, i.e., supervision		same as primary violator	same ceiling for each defendant
plaintiff to prove re-sponsibility	same as in substantive violation			same ceiling for each defendant

Part 14

Enforcement

Although the civil remedies available under part 13 will have the effect of encouraging compliance with the Draft Act, private actions by persons who suffer harm, whatever the deterrent effect of potential civil liability, are not alone a sufficient method of enforcement of the Draft Act's provisions. Whether such actions are brought will depend more on the economic benefits obtainable by a plaintiff than on considerations of furthering the goals of the Draft Act. Equally important, the discovery of an offence or of facts sufficient to prove a sophisticated securities fraud may involve too great an expense to be feasibly undertaken by a private citizen. Thus in order to ensure that matters important to the policy of the Draft Act may be consistently pursued, it is necessary to provide as well other more traditional techniques of enforcement.

Part 14 authorizes the Commission to initiate three types of enforcement activity. The Commission may, of its own motion, initiate investigations for the purpose both of detecting violations or potential violations of the Draft Act and of gathering information relating to its quasi-legislative and policy-making functions and, where quick action is necessary for the protection of investors, it may issue orders requiring the immediate cessation of trading in a specified security or prohibiting a person from dealing with assets held by a violator (a "freeze order"). All such orders of the Commission are subject to judicial review under part 15. The

Commission may also apply to a court for injunctive relief requiring a violator to comply with the Draft Act or for other equitable relief; and the courts are given broad remedial jurisdiction to fashion appropriate remedies. Finally, the Commission may initiate a criminal prosecution for a violation of any of the Draft Act's provisions.

In short the Part provides for investigations by the Commission, civil enforcement remedies both by the Commission and the courts, and criminal penalties to be imposed by the courts. Moreover, to ensure that the policy of the Draft Act is fully considered in any proceeding involving its interpretation, the Commission may appear in any action under it to make its expertise available as a friend of the court.

Needless to say, any enforcement activity may affect the interests and liberties of individuals. Part 14, therefore, in an attempt to provide a reasonable balance that will permit efficient enforcement of the Draft Act without denying civil liberties, contains a number of provisions intended to ensure fair treatment of persons who may be adversely affected by an investigation or other order of the Commission.

Section 14.01

Perhaps the most essential enforcement tools for a regulatory agency are broad powers of investigation so that it may discover and prevent or prosecute violations. Securities commissions are no different in this regard; every Canadian securities act grants such powers and similar powers are also granted to government agencies in other jurisdictions.¹

The Draft Act authorizes the Commission to conduct two types of investigation, one directed at detection of violations or the accumulation of information relating to a particular application and the other at the collection of information in relation to policy formulation either to develop regulations or to propose amendments to the Draft Act itself.² Section 14.01 provides for the former type of investigation and is therefore usually contingent on the existence of an apprehended violation of the Draft Act. However, it may be necessary for the Commission to initiate a fact-finding investigation where no violation has occurred, for

1 See generally, *Leigh*, ch. II; J. WILLIAMSON at 223-32; J. WILLIAMSON, SUPP. at 238-57; Baillie, *Discovery-Type Procedures in Security Fraud Prosecutions*, 50 CAN. B. REV. 496 (1972) (Canada); and see e.g. 3 L. LOSS at 1945-74; 6 *id.* at 4079-4108 (United States); L. GOWER at 604-13 (United Kingdom).

2 Cf. P. ANISMAN, A CATALOGUE OF DISCRETIONARY POWERS IN THE REVISED STATUTES OF CANADA 1970, 13-15 (1975) ("investigative powers").

example, to determine whether an applicant is a fit person for registration under part 8, and subsection (1) ensures that it has power to do so.³ Nevertheless the Commission's powers are slightly more limited than under the provincial source provisions.⁴

Subsection (1) incorporates the substance of the present Ontario Securities Act. Although the Draft Act does not expressly authorize the Commission to define the scope of an investigation as the Ontario act does (s. 21(3)), the Commission will undoubtedly do so by reference to the subject of the investigation.⁵ Similarly the power to appoint experts included in the Ontario act, s. 21(8), has been omitted because it is superfluous; the Commission may appoint any person it wishes to conduct an investigation.

Broad investigative powers like those granted to the Commission necessitate consideration of the civil liberties of persons who are the subject of an investigation and of persons compelled to give evidence. Although the Commission may initiate investigations where it considers it necessary to do so, only a court may authorize the exercise of powers that infringe directly on traditional civil liberties. While the power to undertake an investigation is necessary to the Commission's ability to enforce the Draft Act's provisions, powers of search and seizure are sufficiently drastic that some further check on their exercise is desirable. Subsection (4) therefore requires that a court grant authority to enter and search premises and to remove materials from them.

For similar reasons subsection (7) gives a court power to determine whether such materials were properly seized as well as any question of solicitor-client privilege that may arise in connection with them. The procedure in subsection (7) is based on the Income Tax Act, s. 232, and requires an investigator to seal any seized property concerning which a claim is made so that a court may determine whether it may be used for purposes of the investigation. It enables a person interested in the property to apply to a court to challenge the investigator's authority to remove it either on the basis that it is privileged or that it is not reasonably related to the subject of the investigation.⁶ And subsection (6) makes clear that the powers of investigation are not intended to override any solicitor-client privilege that would otherwise exist.⁷ (The latter subsection is drafted to ensure that the general law relating to

3 *Cf.* Reg. 11.1 under the Commodity Futures Trading Commission Act, in CCH COM. FUTURES L. REP. ¶ 2365.

4 *Cf. e.g.* Ontario Securities Act, s. 21(2).

5 *Cf. Leigh* at n. 271 and following.

6 *See* subsections (4), (6).

7 *See e.g.* *Re Borden and Elliott*, 30 C.C.C. (2d) 337 (Ont. C.A. 1975); *Re B.X. Developments Inc.*, 70 D.L.R. (3d) 366 (B.C.C.A. 1976).

solicitor-client privilege will apply in order not to preclude the application of developments in the law to cases arising under the Draft Act.⁸⁾

A person who testifies in an investigation may be represented by counsel whether or not he is the subject of the investigation (subsection (9)). The Canada Business Corporations Act and the Law Reform Commission of Canada would entitle a person being investigated to be present and represented at all proceedings of an investigation as well.⁹ Under the Draft Act, however, he may be so represented only when he is called to testify. The Draft Act does not grant a general right to be present when other persons are examined because information divulged during the examination might permit a person being investigated to destroy materials before the Commission has an opportunity to see them and because it might permit him to impede an investigation unduly. One purpose of subsection (11) is to preclude the former possibility and it is presumably for these reasons, as well as the technical reason that an investigation does not directly affect a person's rights, that courts in most jurisdictions have refused to grant such a right as a matter of natural justice or "due process".¹⁰

A recent decision of the Supreme Court of Canada distinguished the *Guay* case because a report resulting from an investigation by the Québec Police Commission into the conduct of a member of the Montréal police force had important effects on his rights. The Court therefore held that the officer investigated was entitled to appear with counsel and cross-examine other witnesses.¹¹ Although a report by an investigator may have an impact upon the person investigated, the procedure under the Draft Act is more akin to that in *Guay* than in *Saulnier*. If it has any effect, it will be to influence the Commission to initiate further proceedings and any such proceedings, whether before the Commission or a court, will require a hearing at which the person will have an opportunity to cross-examine all witnesses and to present his own evidence. As a result, an investigation under the Draft Act does not itself adversely affect an investigatee's rights.¹²

A person being investigated is also protected in other ways from an infringement of his liberties. If he is compelled to give

8 Cf. e.g. LAW REFORM COMMISSION OF CANADA, REPORT ON EVIDENCE 31-32 (Evidence Code, s. 42), 81-82 (Comment).

9 See Canada Business Corporations Act, s. 225(2); LAW REFORM COMMISSION OF CANADA, COMMISSIONS OF INQUIRY 34, 48-49 (Working Paper No. 17, 1977).

10 See e.g. *Guay v. Lafleur*, 47 D.L.R. (2d) 226 (S.C.C. 1964); *Hannah v. Larche*, 363 U.S. 420 (1960); cf. Merrifield, *Investigation by the Securities and Exchange Commission*, 32 BUS. LAW. 1583, 1593 (1977).

11 See *Saulnier v. Québec Police Commission*, 57 D.L.R. (3d) 545 (S.C.C. 1975).

12 Cf. *Wiseman v. Borneman*, [1971] A.C. 297 (H.L.).

evidence that is incriminating, his testimony may not be used against him in a subsequent proceeding (subsection (10)). Although the Canada Evidence Act, s. 5, must be expressly invoked by a witness who wishes such protection, the Draft Act follows the Canada Business Corporations Act, s. 226, and prohibits the use of such testimony in a subsequent proceeding, whether or not a witness so requests, to ensure that an ignorant witness who testifies without the benefit of legal advice has the same protection as a more knowledgeable one.¹³

The primary way in which a person may be harmed by an investigation is by adverse publicity deriving from the investigation itself or from adverse conclusions in a published report.¹⁴ Subsection (11) precludes the former type of publicity by requiring that an investigation be held *in camera*. The Ontario Securities Act, s. 24, also prohibits disclosure by a witness, without the Commission's consent, of any facts concerning an investigation obtained as a result of his testifying.¹⁵ A similar provision does not exist in the United States and is not included in the Draft Act as it was thought unnecessarily restrictive.¹⁶ Nevertheless, the Commission's staff is precluded from disclosing such information by section 15.23.

Subsection (13) ensures that a person who may be harmed by the publication of a report or other information about an investigation has an opportunity to be heard so that the requirements of fairness are satisfied. The subsection makes clear that the decision to publish a report rests with the Commission itself and not with the person who conducts the investigation.¹⁷ Paragraph (13)(a) meets the standard required by the courts in such circumstances by requiring that a person be given notice and an opportunity to be heard before an adverse finding is made concerning him.¹⁸ (It is clear, however, that he is not entitled to cross-examine other

13 See also LAW REFORM COMMISSION OF CANADA, COMMISSIONS OF INQUIRY, *supra* note 9, at 36-37; and see LAW REFORM COMMISSION OF CANADA, REPORT ON EVIDENCE 29 (Evidence Code, s. 38), 78-79 (Comment).

14 See e.g. SECURITIES AND EXCHANGE COMMISSION, STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (1977); Logan, *Around City Hall: Many Are Called*, The New Yorker, September 5, 1977, at 71; SEC, Securities Exchange Act Release No. 13612, June 9, 1977, in 12 SEC Docket 773 (June 21, 1977) (report regarding investigation of Gould Inc.).

15 See also OSC Policy No. 3-28, [1976] OSC Bull. 355 (December).

16 Cf. Merrifield, *supra* note 10, at 1594 (SEC states in subpoenas that investigation not intended to reflect adversely on anyone).

17 Cf. Reid, *Shawcross urges appeal system for inquiries*, The Financial Times, September 12, 1977, at 34, col. 1 (recommends appeal before publication of inspectors' report containing adverse findings).

18 See e.g. *In re Pergamon Press*, [1970] 3 W.L.R. 795 (C.A.); cf. Ontario Public Inquiries Act, s. 5(2).

witnesses.) And paragraph (13)(b) requires as well that a person who will likely receive adverse publicity be given an opportunity to read the parts of the publication affecting him so that he may prepare a response. A similar procedure was followed in Britain in the Pergamon affair when Robert Maxwell published a response to the report of inspectors appointed under the Companies Act, 1948, to investigate the affairs of Pergamon Press Ltd.¹⁹ In fact an opportunity to review such a report prior to publication may alone be sufficient to satisfy the demands of due process.²⁰ It is expected that the Commission will adopt regulations establishing procedures for such cases.

A few further matters deserve mention. The provincial legislation makes a person who refuses to comply with a commission order to testify liable for contempt. The Draft Act omits this provision and instead makes it an offence to fail to comply with an order to give evidence under section 14.01 or 14.02.²¹ The penalty is substantial in order to ensure compliance, but if the threat of criminal prosecution is not sufficient, the Commission may also apply to a court under section 14.06 for an order requiring compliance. And if a person disobeys such an order the Commission may then prosecute for contempt as well as under section 14.10.²²

Finally, the subpoena power in subsection (2) and the power to administer an oath in subsection (3) apply both within and outside of Canada. Subsection (2), at the risk of repetition, extends the power to require production to documents outside of Canada in order to ensure that no contrary inference may be drawn.²³ The Commission may, however, avail itself of the general law relating to the taking of foreign evidence without such a provision.²⁴

Section 14.02

Section 14.02 authorizes investigations by the Commission so that it may obtain information relating to policy formulation for the purpose of its regulation-making function or amendments to

19 See also e.g. *Morgan Guaranty Reports on "Transactions in Securities of the City of New York"*, *The Wall Street Journal*, September 12, 1977, at 9, col. 1; *The Financial Times*, September 15, 1977, at 33, col. 1 (advertisement).

20 Cf. Quigley, *Criticism in DOT report attacked by accountants*, *The Times*, December 13, 1977, at 23, col. 1 (accounting firm criticized refusal to allow it to see report prior to publication).

21 See subsection 14.10(3).

22 Cf. LAW REFORM COMMISSION OF CANADA, COMMISSIONS OF INQUIRY, *supra* note 9, at 32-33.

23 See subsection 16.02(5) and Commentary; cf. *Re Royal Bank of Canada*, 14 O.R. (2d) 783, 786 (H.C.); and see, *SEC Asks Congress for Power to Subpoena Foreign Entities*, 392 BNA SEC. REG. & L. REP., February 3, 1977, at A-12.

24 See e.g. Evidence Act, ss. 49-51 (evidence from abroad).

the Draft Act.²⁵ As a result the powers given to the Commission are narrower than those necessary under the preceding section. While the Commission may still compel the attendance and testimony of witnesses, it has less need for powers of search and seizure in a policy-oriented inquiry, and subsection (2) therefore incorporates only the former types of power. The solicitor-client privilege is again preserved, however, as subsection 14.01(6) applies to the provisions referred to in subsection (2).

The Ontario legislation also authorizes both fact-finding and legislative investigations but does not distinguish between them.²⁶ The Draft Act permits the Commission itself to conduct a legislative inquiry because it is not as likely to lead to an exercise of the Commission's adjudicative powers as is an investigation under section 14.01. But the Commission may appoint a delegate to conduct an inquiry as well.²⁷

The Law Reform Commission of Canada has recommended that a person conducting a policy-oriented investigation should not have the power to compel the attendance and testimony of witnesses.²⁸ The only reason given by the Commission is that such powers are not required.²⁹ Nevertheless, it may be useful for the development of policy alternatives to analyze industry practices and particular cases or instances of alleged abuse. In other words, the distinction between a so-called "advisory" investigation and an investigation under section 14.01, although clear in purpose, will often blur in practice.³⁰ Subsection (4) is therefore included. Similarly, the Commission is authorized to compel the production of documents in connection with a policy inquiry, for the power to do so may provide the only method for it to obtain data concerning the needs and practices of securities firms and other participants in the securities market. If there is a legitimate need for confidentiality in a particular case, the Commission may deal with it on an individual basis.

An investigation aimed at detecting a violation of the Draft Act may not be held in public.³¹ An investigation under this section may be because it deals with more general issues and because publicity may be useful to its policy or quasi-legislative purpose (by raising questions publicly and thus inducing further witnesses to appear). However, public proceedings may affect an

25 See generally section 14.01, Commentary.

26 See Ontario Securities Act, s. 21(2); Ontario Securities Act, 1978, s. 11(2).

27 See section 15.09.

28 See, COMMISSIONS OF INQUIRY, *supra* note 9, at 23-25.

29 *Id.* at 24.

30 See e.g. SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (1976).

31 See subsection 14.01(11).

individual's reputation even without the publication of a report. Subsection (5) requires, therefore, that a person who may be adversely affected by testimony in an investigation be given an opportunity to rebut it on the record in the course of the investigation. As a result, a provision similar to paragraph 14.01(13)(a) is unnecessary under this section. But if the Commission publishes a report it must still give a person who is likely to receive adverse publicity because of the report advance notice and time to prepare a response (subsection (6)).³²

Section 14.03

Section 14.03 empowers the Commission to appoint a person to make spot audits of registrants. As the Commission has analogous powers under section 9.12 in respect of registered self-regulatory organizations, it is expected that this provision will be utilized primarily in relation to persons registered under part 8. Spot audits of a registrant's affairs have long been an accepted method of supplementing the audits performed at regular intervals by the self-regulatory bodies and thus provide a useful enforcement tool to ensure that registrants comply with the capital and other requirements under the Draft Act. As under the other investigative provisions in this Part, however, a registrant's duty to supply information to an examiner is made subject to any solicitor-client privilege that may exist.³³

The section derives primarily from the Canadian source provisions.³⁴ The Ontario legislation, however, permits spot audits of the affairs of a reporting issuer as well as of those of a registrant. The power to make a spot audit is intended to supplement the Commission's supervisory powers over registrants so that it may investigate their affairs on a regular and systematic basis without having to invoke the broader investigative powers in section 14.01. As a result, the Draft Act does not make reporting issuers subject to audits under section 14.03. Rather, as investigations of their affairs are likely to be related to an apprehended violation of the Draft Act, it leaves investigations or reporting issuers to section 14.01.³⁵

32 Cf. paragraph 14.01(13)(b) and Commentary.

33 See subsection (3).

34 See *e.g.* Ontario Securities Act, 1978, s. 18.

35 Cf. subsection 8.02(5) and Commentary.

Section 14.04

Section 14.04 brings together several types of “cease trading” orders and empowers the Commission to make them summarily where it must act quickly in order to protect investors. Although no major alteration results from the compression of the source provisions into a single section, there are a number of minor changes.

Subsection (1) incorporates all powers relating to an order to prohibit trading in connection with a distribution, including the power in paragraph (1)(a), which is not contained in the source provisions, to prohibit trading in connection with an illegal distribution.³⁶ (The Canadian source provisions deal separately with a distribution that is in progress and with trading on the basis of a preliminary prospectus before the distribution has begun, and the *ALI Code* treats separately a prospectus and a summary prospectus.³⁷) Because the Draft Act introduces the concept of a block distribution circular and permits the use of a summary prospectus and other sales literature as well as a prospectus and a preliminary prospectus, the section expressly includes all documents used in connection with a distribution. In this respect it is, like the Draft Act itself, somewhat broader than the source provisions.

Apart from paragraph (1)(a) the standards for a cease trading order in connection with a distribution are essentially those relating to approval of a prospectus. Although the standard in paragraph (1)(b) is implicitly contained in paragraph (1)(c) in relation to prospectuses, it is not so contained in relation to the other documents specified; consequently both paragraphs are included on the basis that it is better to have some slight overlap than a potentially large gap.

Paragraph (1)(d) is based on the *ALI Code* which provides that failure of an issuer or selling securityholder “to cooperate in a proceeding is ground for the issuance of a stop order”³⁸ and which in turn is derived from the Securities Act of 1933, s. 8(e). The latter provision relates generally to an inquiry by the Commission to obtain information in addition to that submitted in connection with a distribution. Paragraph (1)(d) attempts to incorporate the standard but limits it by the requirement that the Commission’s request be reasonable.

36 See, *Leigh*, ch. I.E.

37 See Ontario Securities Act, ss. 40(1), 62; Ontario Securities Act, 1978, ss. 67, 69; ALI FEDERAL SECURITIES CODE, ss. 1808(d), (f).

38 *Id.* s. 1808(d)(3).

Subsection (2) authorizes the Commission to issue a cease trading order in respect of securities. A similar provision is included in most of the provincial securities acts in essentially the same form. Orders are usually issued by the provincial commissions where there is abnormal and unexplained market activity in a security or a violation relating to the disclosure requirements of a securities act and they remain in effect until adequate disclosure is made.³⁹ And the power has also been used to prevent manipulation.⁴⁰ Subsection (2) attempts to specify the standards that most frequently provide a basis for cease trading orders in Canada.⁴¹ It should be emphasized that paragraph (2)(a) is applicable even where a notice of a material change has been filed pursuant to subsection 7.03(2). This result is clear from the paragraph itself and an express provision to the same effect, such as Ontario Securities Act, 1978, s. 123(2), is unnecessary.

Paragraph (2)(c) is included, despite its breadth, because the factors that may require a cease trading order are so multifarious that limiting the power by the narrower standards in the preceding paragraphs might deprive the Commission of a necessary remedy in some future case. Nevertheless, concern has been expressed over the potential use of cease trading orders to the detriment of public securityholders.⁴² The provincial commissions themselves have recently adopted policies that attempt to ameliorate unduly harsh results of cease trading orders and have begun to use alternative sanctions to force disclosure from reticent issuers.⁴³ It is expected therefore that the Commission will be influenced by recent experience of the provincial commissions and will exercise its powers equitably, possibly by invoking other remedies like a compliance order under section 14.06 where it is feasible to do so.

Subsection (3) extends a similar power to the Commission in relation to individuals. It permits the Commission to prohibit a

39 See e.g. D. JOHNSTON at 361 n. 13; *Leigh* at nn. 214-21.

40 See *id.* at n. 222.

41 See e.g. *In re Avalanche Industries Ltd.*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, March 18, 1977, at 3 (Corporate and Financial Services Commission); *In re Twentieth Century Explorations Inc.*, [1977] OSC Bull. 185, 187 (August) (order and reasons, respectively); see also D. JOHNSTON at 435, 442, 446 (list of Ontario, Québec and British Columbia orders respectively); and see Ontario Policy 3-34, [1977] OSC Bull. 155 (July) (orders in other jurisdictions).

42 Cf. D. JOHNSTON at 361; *Grover & Baillie*, n. 175.

43 See e.g. Ontario Policy No. 3-31; *Birnamwood Investments Limited*, Decision No. 5275, 8 QSC Bull., No. 29 (July 21, 1977); *Markets: On the Street: The Hard Cell*, The Financial Times of Canada, May 30, 1977, at 31, col. 1 (QSC prosecuting recalcitrant issuers); *Penal Proceedings: Judgments in the Matter of Aurox Mines Ltd.*; *Penal Proceedings: Judgments in the Matter of American Copper Smelting Ltd.*, 9 QSC Bull., No. 3 (January 24, 1978).

person who violates the Draft Act, a regulation or a by-law from trading in a particular security or from trading in securities at all. While the power may seem somewhat draconian, it is not new. A similar provision was contained in the Alberta Securities Act, 1955, s. 91, applicable to brokers and salesmen and the British Columbia Securities Act, s. 77A, is substantially similar.⁴⁴ The other provincial securities acts implicitly grant an equivalent power by authorizing the commissions to deny the exemptions from registration to any person.⁴⁵ In fact the Toronto Stock Exchange has recommended that persons who trade on the basis of inside information be prohibited from trading in securities and several provincial commissions have adopted the recommendation, in effect, by denying the exemptions to such persons.⁴⁶ The approach of subsection (3) is preferable because it achieves the desired result directly. It is also necessary because the Draft Act requires registration only of persons who carry on business as dealers or advisers and thus removes the availability of the denial-of-exemption technique.⁴⁷

In recognition of the fact that the orders authorized by section 14.04 may have to be made quickly if investors are to be adequately protected, the Draft Act, like all of the source provisions, permits the Commission to make such an order summarily. The provincial securities acts permit a cease trading order to be made without a hearing only when a commission believes that the time necessary for a hearing would be "prejudicial to the public interest". Subsections (4) and (5), however, simply give the Commission a discretion to issue such an order because the phrase in the provincial acts provides only the illusion of a standard, without in reality giving any more guidance than the Draft Act.

To ensure that the requirements of natural justice are fulfilled, the Commission must provide an opportunity for a hearing within fifteen days of the order and must give notice of the order and the hearing to each person directly affected as soon as possible after the order is made. If a hearing for a summary order under subsection (1) or (3) is not initiated within the fifteen-day period or if the order is not confirmed after the hearing, it ceases to have any effect. A summary order issued under paragraph (2)(a), however, as under the provincial legislation, may be extended beyond

44 See e.g. *In re Dual Resources Ltd.*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, February 18, 1977, at 1 (Corporate and Financial Services Commission).

45 See e.g. Ontario Securities Act, s. 19(5); D. JOHNSTON at 362-63.

46 See Toronto Stock Exchange, *Submission to the Ontario Securities Commission on Bill 154 - The Securities Act, 1972*, 34-35 (1973); Anisman at 180, n. 179.

47 See generally part 8.

the fifteen days if the information upon which it was based has not been disclosed and become public within that period because a hearing on the question would be superfluous.

Subsection (6) specifies the persons to whom notice must be given in order to avoid a more general provision that might be interpreted to require that personal notice be sent to every holder of the security in question, all of whom are arguably "directly affected" by a cease trading order. Paragraph (6)(c) is included as a residual exhortation to encourage the Commission to send notice to persons other than those specified in paragraphs (a), (b) and (d) who it knows may be substantially affected by its order. And to ensure that the notice becomes generally available the Commission is required to publish it in a regular periodical.⁴⁸ The subsection deals only with notice of an order because hearing procedures are specified in part 15.

Finally, subsection (7) prohibits contravention of a cease trading order by any person. The subsection follows the approach adopted in part 12 and does not specify a mental element. It is expected that the courts will imply an appropriate standard in an action under section 13.16 for damages caused by a violation of the subsection; and a criminal penalty may be imposed for a violation that is committed knowingly or recklessly.⁴⁹

Section 14.05

Section 14.05 rounds out the Commission's powers of direct enforcement by authorizing it to issue a "freeze order" prohibiting a person from dealing with any property under his control and prohibiting others from dealing with property held for him. The section is broad; it is not necessary that a violation of the Draft Act be proved. The Commission may even issue an order under the section where a person with local assets has violated a foreign securities law, as is made clear by the express reference to non-Canadian investors.⁵⁰ Moreover, an order may cover property that is outside of Canada but in the control of a person subject to the order.⁵¹ And as a freeze order must be made with alacrity if it is to be effective, the summary procedure permitted for cease trading orders under section 14.04 is made applicable by subsection (6) to

48 Cf. *e.g.* Dempster Explorations Limited, OSC Weekly Summary, December 16, 1977, at 3A.

49 See subsection 14.10(2).

50 Cf. Rock Enterprises Ltd., Decision No. 5357, 8 QSC Bull. No. 39 (QSC September 22, 1977) (recommending appointment of receiver to protect Québec and foreign investors).

51 See subsection 16.02(5) and Commentary.

orders under this section, including, of course, the time limitations on a summary order.

Section 14.05 contains a more specific standard than the provisions on which it is based. The provincial acts authorize a freeze order when an investigation, a commission decision or a proceeding for violation of a securities act or the Criminal Code is about to be or has been made.⁵² Instead of listing the types of proceedings which provide no more than a background for the issuance of a freeze order, subsection (1) specifies the standard that should influence the Commission to make an order, namely, that the Commission believes it necessary to prevent a violator from dealing with property in his possession or under his control in order to protect investors. In short, the section empowers the Commission to prevent a violator from removing from the jurisdiction or otherwise disposing of assets actually belonging to investors before proceedings are initiated or completed. Such a power is essential to the effective enforcement of the Draft Act, especially in light of the increasing internationalization of financial activities and the ease with which offshore affiliates may be established and utilized.⁵³

A number of more technical comments are necessary. The provincial acts apply only to "funds or securities". Subsection (1), however, extends the possible scope of a freeze order to include all property under a violator's control, for it makes little sense to distinguish between fungible and non-fungible property in circumstances warranting a freeze order. The provincial acts also limit the scope of an order relating to funds or securities in the person's possession to property "of clients or others". Again, where property is fungible such a limitation makes little sense, especially when an affected person may apply to the Commission to modify the order, for example, to release funds or other property that need not be "frozen" to protect investors. And similarly the Commission is not required to specify the property subject to an order, as such a requirement would of necessity limit the effectiveness of orders by confining them to specific property of which the Commission is aware.

The concluding clause of subsection (1) indicates the duration of a freeze order and the necessity for further action by the Commission. It emphasizes the fact that a freeze order is intended only as an intermediate remedy to retain assets for investors and the expectation that when such an order is made the Commission

52 See e.g. Ontario Securities Act, 1978, ss. 16(1)(a)-(d).

53 See e.g. *Re I.O.S. Ltd.*, 7 N.B.R. (2d) 316, 324-25, 327, 332-33 (N.B.S.C. 1973), *affirmed*, *id.* at 311 (N.B. App. Div. 1973).

will also be pursuing other remedial avenues in order to resolve the case.

Subsection (2) is taken directly from the source provisions.⁵⁴ It is intended to protect investors who have bought securities from the person in question that have entered the clearing process before the Commission makes an order unless the Commission thinks that there are countervailing considerations that should prevail. Consequently, subsection (2) ensures that the Commission turn its mind to the question, and deals with it expressly if at all.

Subsection (3), on the other hand, substantially modifies the source provisions. The provincial provisions state that a freeze order applies only to the branches or offices of a bank, loan or trust corporation named in it and appear to have been included in order to protect such institutions from liability. As a result a provincial commission's power to freeze assets is in fact limited unless it knows in which branches a person has accounts (or a safety deposit box). However, with the increasing use of computerized record-keeping, it should be relatively simple for the head office of a bank to determine whether a person named in an order has an account and to identify the branch or subsidiary in which it is maintained.⁵⁵ (Subsidiaries are included to ensure that accounts held offshore in a subsidiary of a Canadian bank may be covered.)⁵⁶ In fact, it is arguable that an order delivered to the head office of any such institution can easily be transmitted to all of its branches and subsidiaries. And it should not create a great burden for the branches to then check whether the named person has an account or a safety deposit box. Paragraph (3)(a) therefore adopts the substance of the source provisions and paragraph (b) extends the requirement to include all branches of an institution if a copy of the order is sent to its head office, if it has reasonable time to notify its branches and if the branches have a reasonable opportunity to check their records. The latter condition, in subparagraph (3)(b)(iii), ensures that an unreasonable obligation cannot be imposed on a deposit-taking institution and presumably in light of it the Commission will not issue such an order to an institution that does not have a computerized system of record-keeping for its accounts.

Some concern was expressed over the danger of an order under paragraph (3)(b) resulting in the freezing of the account of a person whose name is the same as the person named in the order and over the liability of a bank to such a customer. This is a problem

54 See Ontario Securities Act, s. 26(1); Ontario Securities Act, 1978, s. 16(1).

55 See e.g. Grindlay, *Computing in Canadian Banks*, 42 BUS. QUART. 85 (Winter 1977).

56 See section 2.47 ("subsidiary"); and see *Re Royal Bank of Canada*, 14 O.R. (2d) 783 (H.C. 1976).

with which the Commission is expected to be able to deal. As applications to the Commission for modification of a freeze order are contemplated under the section, the Commission might delegate its powers to a senior staff member in order to facilitate applications on such matters and their speedy disposition.⁵⁷

Indeed, subsection (4) authorizes any person directly affected by a freeze order, whether or not named in it, to apply to the Commission for modification of the order. The express authorization is included to emphasize the availability of such an application in connection with a freeze order the potential effects of which may be severe. The Commission may, however, reconsider and modify any of its orders as is made clear by section 15.16 and subsection 15.19(8). Subsection (4) therefore creates no negative implication with respect to reconsideration of other types of Commission orders.

Subsection (5) permits the Commission to register a freeze order under any registry system dealing with property. The subsection is narrower than the source provisions which authorize such a notice wherever any proceeding has been or is about to be initiated whether or not a freeze order has been issued. However, it is broader than the source provisions in that it applies to all types of property, whereas the provincial acts are limited to land and mining claims. The effect of a notice is not stated in the provision so that registration may have whatever effect the particular provincial law accords it. Presumably, however, a notice pursuant to subsection (5) will always invoke the constructive notice provisions, if any, of the registration system in which it is filed.

Section 14.06

Section 14.06 authorizes the Commission to apply to a court to enforce the provisions of the Draft Act, regulations, by-laws and its own orders and a court may restrain a violation of or require compliance with the legislation or a Commission order. Subsection (1) is drafted more simply than the source provisions in that it merely authorizes an application by the Commission. The court's power to grant an order is implicit in the subsection and is reinforced by section 14.09 which authorizes any ancillary relief necessary to effectuate the Draft Act's purpose. As a result, it is not necessary to specify in the section an order directing officers of a corporation to cause it to comply with or refrain from violating the Draft Act.⁵⁸

57 *See* section 15.09.

58 *Cf.* Ontario Securities Act, 1978, s. 122(1)(b).

It might at first appear redundant to include a Commission order as a basis for an application under subsection (1), for such an order will itself usually be based upon a violation of the Draft Act.⁵⁹ A Commission order is included, however, to avoid the need to prove again before a court the violation upon which the order was based. It is expected that the courts will give appropriate deference to such orders and will avoid turning an application under the section into a proceeding for review, which is available under and for which procedures are specified in part 15. However, when the basis of an application is a summary order under section 14.04 or 14.05, it would not be inappropriate for a court to regard the merits of the order somewhat more carefully than in other cases.

The source provision in the *ALI Code* includes a standard for the granting of an injunction or compliance order, namely, that there be a reasonable likelihood that the violation in question will continue or be repeated. The standard is that usually applied by the courts on an application for an injunction.⁶⁰ The standard is clearly the correct one; it is, therefore, not essential that the conduct upon which an order is based be performed intentionally or even recklessly. Rather such matters are merely factors indicating the likelihood of repetition.

The Draft Act specifies neither the standard in the *ALI Code* nor a *scienter* requirement.⁶¹ Rather, it achieves the same result as the former standard by substituting a "restraining order" for the injunction terminology, as was done in the Canada Business Corporations Act, to ensure that the stringent criteria relating to balance of convenience generally applied to injunctions in litigation between private parties are not applicable. And it leaves to the determination of the courts on particular applications the question of whether conduct, including negligent conduct, of a defendant is sufficient to indicate the need for an order. Courts in Canada, as in the United States, tend to apply less stringent criteria in an action by a public official to enforce a statute.⁶² And similar criteria have been applied in an action for an interlocutory injunction to enforce a cease trading order issued by the Quebec Securities Commission.⁶³ In short, the combination of the "re-

59 See e.g. section 14.04; but see section 5.07.

60 See ALI FEDERAL SECURITIES CODE, s. 1819(a), Note; see also e.g. Securities and Exchange Commission v. Bausch & Lomb Inc., 565 F.2d 8 (2d Cir. 1977); Leigh, ch. I.C.; Comment, *Scienter and SEC Injunction Suits*, 90 HARV. L. REV. 1018 (1977).

61 See section 2.15, Commentary.

62 See e.g. A.G. Ont. v. Grabarchuk, 11 O.R. (2d) 607 (Div'l Ct. 1976); cf. Securities and Exchange Commission v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976).

63 See Commission des Valeurs Mobilières du Québec v. Parent, 7 QSC Bull., No. 48, November 30, 1976 (Que. S. C. 1976).

straining order” terminology and the standards usually applied in Canada in similar actions for an injunction obviate the need to specify a standard in the Draft Act.

Subsection (2) is intended to incorporate into the Draft Act a concept of primary jurisdiction in the self-regulatory agencies to enforce their own by-laws. Indeed, part 9 of the Draft Act implies that the self-regulatory organizations rather than the Commission or the courts have primary responsibility for the enforcement of their by-laws. Nevertheless, it is necessary to give the Commission residual discretion to enforce by-laws even where the relevant self-regulatory organization is capable of doing so, and paragraph (2)(b) accomplishes this result.

Section 14.07

Section 14.07 authorizes the Commission to apply to a court for the appointment of a receiver where it believes one is required to protect the interests of investors or other persons whose interests may be affected by the conduct of a person who violates the Draft Act or whose registration is revoked or suspended. The standards specified in subsection (1) as conditions for the appointment of a receiver are more stringent than those in section 14.05 for freeze orders and than those in the Ontario Securities Act, 1978, which permits an application for a receiver where the Commission could issue a freeze order or where a registrant violates the capital requirements. Because of the seriousness of the exercise of the power under this section, it seems reasonable to require that a violation has occurred (or that a registration be suspended or revoked) as a prerequisite to the issuance of an order.

As it may be necessary for the Commission to act quickly to ensure that the assets controlled by a violator are not dissipated, subsection (2) authorizes an *ex parte* application. The subsection is included to ensure a uniform procedure in all provinces and to make clear that the Commission may apply *ex parte*.⁶⁴ The temporal limitation too derives from the new Ontario act, in which it has been extended from eight to fifteen days.⁶⁵ It is likely that the Commission will frequently need to act quickly in cases in which it makes use of the section.⁶⁶ This factor, combined with the delays that are often involved in an application to appoint a receiver, may compel the Commission to make a freeze order under section 14.05

64 Cf. Ontario Securities Act, 1978, s. 17(3).

65 Cf. Ontario Securities Act, s. 27(3).

66 Cf. e.g. *Sigurdson v. Fidelity Insurance Company of Canada*, 2 Bus. L.R. 1, 6 (B.C.S.C. 1977) (registrant had \$200,000 capital deficiency).

before it makes an application, even for an *ex parte* order, under this section.⁶⁷

Because the appointment of a receiver affects creditors as well as investors, the standards that a court must apply under the section are broader than those which may influence the Commission in making a freeze order. A court must consider the interests of all creditors and not just investment clients or securityholders of the violator. The Draft Act does not, however, specify the powers of a receiver as the provincial acts do. (In fact, the provincial acts merely give a person appointed the powers of a receiver and "specify" that he may "wind up or manage the business and affairs" of the violator, if the court so orders.⁶⁸) Rather, the Draft Act leaves the specification of a receiver's powers for the court; when it orders his appointment it may under section 14.09 make any ancillary orders it thinks necessary.⁶⁹

Although a suspension or revocation of a registration will usually be based upon a violation of the Draft Act, a self-regulatory organization may be suspended from registration if it becomes unable to continue to perform its duties under part 9 or 10. Paragraph (1)(b) is therefore included to ensure that the section is applicable to registered self-regulatory organizations and the reference to "members" of a registrant follows.

Section 14.08

Section 14.08 contains a number of procedural provisions to facilitate the Commission's enforcement and administration of the Draft Act. Subsections (1) to (3) generalize the provincial source provisions, which apply only to insider trading, and expand on the *ALI Code* which applies only to investment companies.⁷⁰ Thus the Commission may be authorized to bring a "derivative" action on behalf of an issuer or a substitute action on behalf of securityholders or to intervene in an action, but as the section

67 See e.g. *Notice: British Canadian Commodity Options Limited*, OSC Weekly Summary, October 28, 1977, at 1A; *Markets: On the Street: OSC to appoint receiver*, The Financial Times of Canada, November 6, 1977 at 41, col. 1 (cease trading order issued March 23, 1977, application for receiver in April 1977 and court order to appoint receiver on October 27, 1977); cf. e.g. *Rock Enterprises Limited*, Decision 5357, 8 QSC Bull., No. 39 (September 22, 1977) (recommendation to Minister to appoint receiver; freeze orders issued by Commission previously).

68 See e.g. Ontario Securities Act, 1978, s. 17(4); cf. *In re Donaldson Securities Ltd.*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, July 29, 1977, at 1 (notice that receiver-manager appointed).

69 Cf. *Securities and Exchange Commission v. Investors Leasing Corp.*, 560 F.2d 561 (3d Cir. 1977).

70 See generally, Leigh, ch. I.B.17.

applies only to actions under the Draft Act, it is limited to causes of action under part 13.

The section is narrower than the provincial source provisions in one regard, namely, that it does not authorize an application to a court by a securityholder to require the Commission to bring an action on behalf of an issuer.⁷¹ Only the Commission may apply for permission to do so. The Draft Act envisages a more active enforcement role for the Commission by means of litigation than do the provincial acts. As the Commission will have to determine its own litigation priorities in light of the policies of the Draft Act that require enforcement and of its resources, both financial and manpower, it is necessary that the Commission select its own cases. Having cases thrust upon it that may not be important for policy development, albeit important to some investors, may disrupt its ability to plan and execute its enforcement program. An investor may, however, always apply to the Commission and attempt to convince it to make an application under subsection (1) or (2) either on his behalf or on that of an issuer.

The standards for a court's approval of an application under subsections (1) and (2) derive primarily from the Canada Business Corporations Act and have been modified in light of the Draft Act's broader scope. A court must be satisfied that there are reasonable grounds for believing that a cause of action exists under part 13 (paragraphs (1)(a) and (2)(a)) and must also find that a condition specified in paragraph (1)(b) or (2)(b) exists. The requirement in paragraph (1)(b) that reasonable notice be given to an issuer is parallel to the source provisions. Presumably the Commission will pursue an action on behalf of an issuer only where the directors refuse to do so because of a conflict of interest or where there is a policy goal of the Draft Act that should be furthered and the directors of the issuer have no desire to do so, for example, where a senior officer of the corporation has traded with inside information. Similar criteria will likely apply to interventions by the Commission where the plaintiff is an issuer.⁷²

It is expected that the Commission will avail itself of subsection (2) where there is a large plaintiff class of securityholders each of whom has a relatively small interest so that the economic incentives are not sufficient to warrant an action by an individual securityholder. It is worth emphasizing that "securityholder" in subsection (2) includes a former securityholder who has sold securities as a result of a violation of the Draft Act. It is clear in light of the purpose of section 14.08 and of the remedies in part 13 that the

71 See *e.g.* Ontario Securities Act, 1978, s. 132.

72 See subsection (3).

term should be so interpreted and it is likely that a court would do so. Nevertheless, if there is any doubt about this interpretation, "investor" could be substituted.

The Commission may also bring an application under subsection (2) on behalf of securityholders where the defendant is a foreign resident, that is, to enforce the rights of Canadian investors against persons outside of Canada. And the fact that a defendant is not in Canada may be a determinative factor under paragraph (2)(b). Indeed, in view of the increasing internationalization of the securities markets, the Commission's power to bring such an action is important and will permit the prosecution of claims that otherwise might not be enforceable.⁷³ Presumably the Commission would be entitled to enforce judgments obtained pursuant to such actions in a foreign court and even to initiate such actions in a foreign court that will accept jurisdiction, for example, where the defendant does not reside and has no assets in Canada.

The Commission is likely to apply for intervention in an action on behalf of securityholders when the plaintiff who has control of the action is pursuing his own ends to the detriment of the other class members or other securityholders or when a plaintiff who has initiated an action under part 13 is incapable for economic or other reasons of pursuing it diligently. Because subsection (3) is operative only after action has been taken, there is no requirement that the Commission have reasonable grounds for believing that a cause of action exists under the Draft Act. If there is any doubt about this matter, the defendant may move to dismiss for failure to state a cause of action.

If the Commission wishes to take carriage of an action or intervene in one as a party, it must apply to a court under subsections (1) to (3). However, the Commission may wish to place its views on the law, usually on an interpretation of the Draft Act, before a court seized of the issue, without taking an active role on the facts of a particular case. Subsection (3) therefore authorizes the Commission to apply to a court for leave to *appear* as a friend of the court, and the court may permit it to do so on terms that it considers appropriate. The provision enables the Commission to make an application in any action under the Draft Act whether it involves the provisions of the act itself, a regulation or a bylaw of a self-regulatory organization. On such an application the Commission's purpose would be to express its views on the interpretation or application of the Draft Act rather than on the factual merits of the case. The subsection applies to "actions" rather than proceedings to make clear that the Commission's role as friend of

73 See, *Hebenton & Gibson* at n. 351 and following.

the court is limited to actions by others and not to proceedings under part 15 to review a Commission decision. (The Commission's right to be heard in review proceedings is dealt with in subsections 15.19(4) and 15.20(4).)

Subsection (3) gives the Commission broad powers to make an application to be heard for several reasons. The Draft Act is complex and the Commission, which is responsible for its administration and which will have expertise in the securities market, has a substantial interest in its interpretation and may be helpful to a court that must make a decision regarding it. For similar reasons a long-standing and widespread use of the technique both by private groups and regulatory agencies exists in the United States. Although there is not an equally strong tradition of *amicus curiae* appearances in Canada, the Attorney-General is entitled to appear in a private action to argue the public interest on an *amicus* basis.⁷⁴ The Commission as a government agency is in an analogous position.

There is as well a long-standing practice of permitting interested parties to appear on matters referred to the courts for their opinion, and the Ontario Court of Appeal has recently refined its procedures concerning notice and entitlement to appear on such matters.⁷⁵ Perhaps more important, the Supreme Court of Canada has in recent years been increasingly liberal in permitting such arguments⁷⁶ and the tendency has begun to trickle down to lower courts as well.⁷⁷ Nevertheless, as the rules of court relating to the appearance of regulatory agencies as *amicus curiae* in actions involving the legislation which they administer are not yet fully developed in Canada, subsection (3) is intended to establish a presumption in favour of the Commission's right to appear in that capacity.

If the Commission adopts an active enforcement policy, it is likely that not all of the actions initiated by it will proceed to trial but that a substantial number will be settled as a result of pretrial

74 See e.g. *In re Alfred H. Pehlke*, [1939] 4 D.L.R. 725, 726 (Ont. H.C.); and see Dickens, *A Canadian Development: Non-Party Intervention*, 40 MOD. L. REV. 666, 672 (1977).

75 See e.g. *In the Matter of the Constitutional Questions Act: A Notice of Reference to the Ontario Court of Appeal Re: Legislative Privilege*, *The Globe and Mail*, July 22, 1977, at B2, col. 7; *The Toronto Star*, July 22, 1977, at B7, col. 1 (identifying interested parties and inviting others with an interest to file a statement of the issues and authorities to be argued by them and court "may" permit them to appear; submissions open to examination by others appearing).

76 See e.g. *R. v. Morgentaler*, 30 C.R.N.S. 209 (1975).

77 See e.g. *R. v. Simons* (B.C. Prov. Ct., June 30, 1977 unreported) (*amicus curiae* appearance on behalf of B.C. Institute of Chartered Accountants); and see, *Re Clark*, 81 D.L.R. (3d) 33, 36-38 (Ont. H.C. 1977).

negotiations.⁷⁸ As a result the policy of the Commission, both in relation to enforcement and the substantive requirements involved in individual cases, will be reflected in the settlements accepted by it. Subsection (4) therefore encourages the Commission to publish a summary of the terms of settlement of all actions so that the policy indicated by them is readily available. The Commission is required by subsection 15.10(5) to publish a regular periodical in which such summaries may easily be included. This practice has long been followed in the United States, especially in relation to antitrust actions.⁷⁹ In fact, some agencies in the United States have adopted procedures requiring disclosure of proposed consent decrees and an opportunity for public comment before their submission for court approval.⁸⁰ Although it is not required to do so, the Commission has the discretion to adopt similar procedures should it consider them advisable.⁸¹ Paragraph 15.11(3)(c) reinforces the provision by requiring the Commission to include in its annual report a summary of the types of settlement terms to which it has agreed.

Section 14.09

Section 14.09 is intended to ensure that a court may make any remedial order it considers necessary in any proceeding under the Draft Act.⁸² Thus it may award equitable remedies even in an action for damages; for example, it may appoint a special agent to ensure that proper disclosure is made to shareholders in the future.⁸³ The use of ancillary remedies is in fact now common in the United States,⁸⁴ and similar equitable foundations exist in

78 Cf. *e.g.* SECURITIES AND EXCHANGE COMMISSION, REPORT ON DRAFT RECOMMENDATIONS PRESENTED TO THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES CONCERNING CONSENT DECREE SETTLEMENTS 1n.2 (December 1976) (approximately 90% of actions settled by consent).

79 See *e.g.* ANTITRUST CONSENT DECREES 1906-1966: COMPENDIUM OF ABSTRACTS (American Enterprises Institute for Public Policy Research 1968); SEC, Litigation Release No. 8090, August 31, 1977, 12 SEC Docket 1659 (consent decree entered by court: SEC v. Delorenzo).

80 See *e.g.* Johnson Products Company v. FTC, BNA ANTIT. & TRADE REG. REP., March 15, 1977, at H-1 (7th Cir. 1977).

81 But see SECURITIES AND EXCHANGE COMMISSION, REPORT, *supra* note 78.

82 See *e.g.* Leigh following n. 210; Securities and Exchange Commission v. Lummis, [1977-78 Transfer Binder] CCH FED. SEC. L. REP. ¶ 96,245 (N.D. Cal. 1977) (requiring disgorgement of profits).

83 See paragraphs (b), (e); cf. *e.g.* Securities and Exchange Commission v. Beisinger Industries Corp., 421 F. Supp. 691 (D. Mass. 1976), *affirmed*, 552 F.2d 15 (1st Cir. 1977).

84 See *e.g.* Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); Levine and Herlihy, *SEC Enforcement Actions*, 10 REV. SEC. REG. 951 (March 30, 1977).

Canadian law.⁸⁵ In short, section 14.09 mandates the courts to devise remedies appropriate for the furtherance of the objectives of the Draft Act.

The list of possible remedies in paragraphs (a) to (e) is therefore only illustrative. A court may devise further remedies as appropriate, for example, for issuers that sell securities in Canada. It may be desirable in some cases to limit the roles that a particular person may play in the management of a reporting issuer.⁸⁶ In fact, similar orders have been made with regard to Canadian corporations in other jurisdictions in similar circumstances.⁸⁷

Section 14.10

This section creates the criminal penalties for a violation of the Draft Act and, in accordance with the approach in parts 12 and 13, establishes the standards for criminal liability. A person is liable if he violates the act, a regulation, a by-law or a Commission order knowingly or recklessly. The “knowingly” standard is adopted in order to clarify the question of specific intent in respect of the provisions that describe the prohibited conduct.

As has been frequently suggested, the fines for securities fraud are generally low, especially in light of the large amounts that violators often gain as a result of their fraudulent schemes.⁸⁸ Consequently, under the Draft Act the amounts have been increased and a uniform maximum fine applies to all offenders, whether individuals or corporations. (The provincial acts distinguish between the two, usually creating a maximum of \$2,000 for individuals and \$25,000 for corporations.⁸⁹) However, the Draft Act does attempt to distinguish offences on the basis of their seriousness. Thus misrepresentations, violations of most of

85 See e.g. *Merchants Express Co. v. Morton*, 15 Gr. Ch. 274 (1868) (equitable lien imposed to preserve property purchased with stolen funds); cf. Sarna, *Aspects of the Law of Judicial Sequestration in Québec*, 23 MCGILL L.J. 508 (1977); and see *Rasu Maritima S.A. v. Perusahaan Pertambangan Minyakdangas Bumi Negara*, [1977] 3 W.L.R. 518, [1977] 3 All E.R. 324 (C.A.) (discretion of court to make interim order freezing local assets of nonresident defendant); *In re John Barry Enterprises Ltd.*, *The Times*, October 27, 1977, at 16, col. 7 (Ch.); but see *Siskina v. Distos Compania Naviera S.A.*, [1977] 3 W.L.R. 818 (H.L.) (must be valid local cause of action before interim order will issue).

86 See e.g. *Leigh* following n. 61; and see *Securities and Exchange Commission v. American Beef Packers, Inc.*, Current, CCH FED. SEC. L. REP. ¶ 96,079 at 91,876 (D. Neb. 1977) (defendant prohibited from acting as officer or director of defendant corporation).

87 See e.g. *SEC v. Canadian Javelin Limited*, 73 Civil 5074 (S.D.N.Y. 1974) (consent decree).

88 See e.g. *Leigh*, ch. I.A.1; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1517(a), Comment (5).

89 See e.g. *Ontario Securities Act*, s. 137.

the prohibitions against fraudulent conduct under part 12, failure to file a registration statement or a prospectus, and failure to register are dealt with in subsection (1) and are subject to a fine of \$25,000 (the amount applicable only to corporations under the provincial legislation), to ten years imprisonment or to both.⁹⁰ The ten-year figure comes from the anti-fraud provisions of the Criminal Code. (The *ALI Code* imposes a maximum five-year sentence.) All other violations of the Draft Act and of Commission orders are subject under subsection (2) to the lesser penalties of \$5,000, imprisonment for one year or both. The seriousness of the offences under both subsections is emphasized by the fact that they are classified as indictable like the fraud provisions in the Criminal Code.

Given the seriousness of the violations, especially those included in subsection (1), it is still arguable that the maximum penalty is insufficient. The emphasis of the Draft Act, however, is on compensation for the economic harm caused by such violations which, under part 13, may in some circumstances be substantial. As a result the \$25,000 and \$5,000 figures appear to provide a reasonable balance.

Subsection (3) deals with offences that are not directly harmful to investors. As a result they are treated as less serious than those in the preceding subsections; the penalties are lower and may be imposed by way of summary conviction. Concomitantly the standard of proof is also lower and the burden of proving reasonable excuse for an offence is on an accused. In any event, it is unlikely that a situation will arise in which the "defences" in subsections (4) and (5) will apply to an offence under this subsection.

Subsection (4) creates a new defence analogous to the more general provision in the provincial legislation that insulates persons who act "in compliance or intended compliance with" the securities act from both criminal and civil liability.⁹¹ No analogous immunity from civil liability is provided under the Draft Act except for the employees of self-regulatory organizations.⁹² And even with regard to criminal liability the Draft Act is more restrictive in that it specifies an objective standard of reasonable reliance on its provisions.

Although the *ALI Code* initially provided a similar defence, it was deleted so that the issue might be "left to judicial develop-

90 See, Leigh at nn. 57-58.

91 See e.g. Ontario Securities Act, s. 145(2).

92 See section 16.11.

ment”.⁹³ After some discussion of the provision in the Draft Act, the advisers to the study were evenly divided and the provision is, therefore, included.⁹⁴

The initial provision in the *ALI Code* provided merely that reasonable reliance is evidence that an offence was not committed intentionally or recklessly. However, where the requirements of subsection (4) are met, even under the *Code's* provision, they are likely to negative the *mens rea* required for an offence, and it is difficult to conceive of a situation in which a person who fulfills them should be found guilty.⁹⁵ The section therefore adopts the recommendation in *Leigh* and follows the approach of the Proposed Federal Criminal Code, s. 609.⁹⁶ Given the complexity of securities laws, a person cannot in most cases bring himself within the subsection unless he consults a lawyer, reveals all material facts to him and follows his advice.

The common law principle that ignorance of the law is no excuse is, of course, also applicable here. Thus a person may be guilty of an offence under the Draft Act even though he had no knowledge of the specific provision that he violated at the time he did so. This principle is expressly included in the *ALI Code*, s. 1821(g), but is omitted from the Draft Act as it is not necessary to repeat it. Subsection (5), however, modifies it slightly in relation to sentencing for a violation of a regulation promulgated under the Draft Act, an order of the Commission or a by-law. Such a violation committed by a person who was unaware of the regulation, order, or by-law, may not result in a sentence of imprisonment. But as the violator must have committed the violation knowingly or recklessly, he may still be fined. The limitation is an attempt to achieve a fair middle ground by ameliorating the potential penalty without altogether removing the deterrent element of the offence provisions.⁹⁷

Section 14.11

This section creates secondary liability for offences under the Draft Act. The initial version of the section was based upon the Criminal Code of Canada, ss. 21 and 22, and the *ALI Federal Securities Code*, s. 2006(c), and included only persons who aided and abetted another in the commission of an offence. The section

93 ALI FEDERAL SECURITIES CODE, s. 2007, Note (1); see also *id* Reporter's Revision of Tent. Drafts Nos. 1-3, s. 1517(b)(3).

94 See, *Leigh* at nn. 62-65 and following.

95 See e.g. *R. v. Sihler*, 13 O.R. (2d) 285, 291 (C.A. 1976).

96 See, *Leigh* at n. 65 and following.

97 See also, *Leigh* at nn. 66-67 (recommending inclusion of this provision).

has been modified, however, to include acquiescence by controlling persons, by directors and officers of issuers and by persons acting in a supervisory capacity over another who violates the Draft Act.⁹⁸ In light of the knowing or reckless standard in the section, the term merely ensures that directors and control persons cannot turn a blind eye to offences committed by their corporation or their subordinates.

98 Cf. Canada Business Corporations Act, s. 243(2).

Part 15

Administration

Part 15 contains the administrative provisions of the Draft Act. It establishes a commission, the "Canadian Securities Commission", defines its structure, specifies its objects and generally prescribes its powers and the methods by which they may be exercised, all in a manner that leaves the Commission the maximum flexibility to establish its own procedures and to delegate its tasks to its employees and to others within the limits imposed by procedural fairness. In addition, it encourages the Commission to cooperate with other government agencies, federal, provincial and international, where its activities affect institutions regulated by them, and permits a maximum amount of federal-provincial cooperation both in appointments to it and in its activities.

Although the substantive jurisdiction of the Commission is usually granted in other parts of the Draft Act, part 15 deals with its exercise in general terms. The Part authorizes the Commission to make regulations and orders, the latter consisting of decisions directed at particular individuals or institutions and the former of legislative decisions regulating internal or procedural matters, classifying persons, securities and filings or specifying disclosure requirements, and specifies the procedures for the exercise of its powers by either method. Thus before it makes an order the Commission must provide notice and an opportunity to be heard to affected persons and must comply with the rules of natural justice.

Similarly the Commission must provide notice of proposed regulations and give interested persons an opportunity to make representations concerning them.

As is evident from the above and from the preceding parts of the Draft Act, the Canadian Securities Commission is envisaged as a quasi-independent regulatory agency created to administer the Draft Act. In doing so it will perform adjudicative and quasi-legislative functions and supervise the enforcement of the Draft Act's provisions, including investigations of possible violations. The mixture of functions is a useful means to enable the Commission to accumulate experience with the Draft Act in as many ways as possible so that it may better perform its regulatory role. The securities market is a complex mechanism, the regulation of which requires thoughtfulness, attention to potential consequences in a number of areas and, therefore, substantial expertise in its workings and in the scheme of the Draft Act. The experience that the Commission acquires in one function will undoubtedly aid it in the performance of its other functions.

Nevertheless, as part of the enforcement of the Draft Act involves adjudicative decision-making there may be some questions of basic fairness resulting from an apprehension of bias if the Commission itself performs investigative or enforcement as well as adjudicative functions. Consequently part 15 permits the Commission to delegate all of its functions other than rule-making. In fact, it contemplates that specific enforcement decisions will be made by the Commission's staff and that initial disciplinary adjudications will be presided over by an officer who performs no other role in relation to a case on which he sits.¹ The Commission may thus perform only a reviewing function in respect of adjudications. In other words it may hear appeals from decisions of its delegates to ensure consistent application of its policy and of the provisions of the Draft Act in administrative proceedings.²

The structure of the Commission and of part 15 may at first appear to be contrary to the approach adopted in recent federal legislation concerning regulatory agencies.³ However, although the Part does not expressly provide for directions to the Commission from the Cabinet, that is, the executive branch of the government, as the recent bills do, the Commission is neither insulated

1 See section 15.09 and Commentary.

2 See section 15.18.

3 See e.g. An Act to amend the National Transportation Act, Bill C-33, 30th Parl., 2d Sess. (First reading January 27, 1977); Telecommunications Act; and see generally, Howard at nn. 127-33; H.N. Jänisch, *The Role of the Independent Regulatory Agency in Canada*, paper presented to Administrative Law Subsection, Canadian Association of Law Teachers, Fredericton, New Brunswick, May 30, 1977.

from political supervision nor from other traditional means of supervision of administrative action. The exercise of the Commission's power to make regulations is subject to the approval of the Minister or the Governor in Council to ensure political supervision over the Commission's policy-making functions. In any event, the Commission exercises only relatively specific regulatory powers in respect of the securities market, few, if any, of which are directed at society in general.⁴ The approach to subordinate legislation provides an additional safeguard through the open procedure required under the Part.⁵ Moreover, such regulations will be subject not only to the scrutiny of the Deputy Minister of Justice and the Standing Joint Committee on Regulations and other Statutory Instruments under the Statutory Instruments Act,⁶ but also to judicial review under the provisions of this Part to ensure that they are made in furtherance of the statutory purpose approved by Parliament in the Draft Act. Part 15 similarly ensures judicial review of adjudicative decisions of the Commission that in most regulatory schemes would not be subject to direct political supervision.⁷

Because the scope for Commission policy-making tends to be relatively narrow, the Draft Act thus adopts a scheme that provides for judicial review of all types of Commission decision-making and for ministerial or Cabinet review of Commission regulations to ensure that the Commission operates within its mandate and is responsible to the political process in its policy-making, and that it does both in open and fair proceedings.

Section 15.01

Section 15.01 establishes the Canadian Securities Commission and specifies the number of commissioners, their terms of office and method of appointment. The section generally follows the federal source provisions and in doing so leaves substantial flexibility to the Governor in Council concerning appointments and to the Commission itself concerning internal matters such as the quorum for Commission meetings or hearings.⁸ Subsection (1) specifies only a maximum number of full- and part-time commissioners and thus gives the Cabinet discretion to appoint as many as are necessary to handle the administration of the Draft Act and

4 Cf. P. ANISMAN, A CATALOGUE OF DISCRETIONARY POWERS IN THE REVISED STATUTES OF CANADA 1970, 10 (1975) (polycentric powers).

5 Cf. H.N. Jänisch, *supra* note 3, at 66-69; *Grover & Baillie*, n. 205.

6 S.C. 1970-71-72, c. 38, ss. 3, 26.

7 Cf. e.g. Bill C-33, s. 3.2; but see *Telecommunications Act*, ss. 11-12.

8 See e.g. section 15.13.

to perform the Commission's duties.⁹ It is expected that the Commission will have regional offices across Canada and, whether or not such offices are established, the Commission will conduct its adjudicative and possibly other hearings in regional centres selected on the basis of the volume of the workload in a given region.

Even if, as is likely, a quorum of the Commission will require one full-time commissioner, such hearings will be facilitated by the appointment of part-time commissioners from the various regions in Canada, including members of provincial securities commissions. The availability of part-time commissioners, including provincial administrators, increases the possibility of finding competent and knowledgeable appointees for a commission as specialized as the Canadian Securities Commission is likely to be, especially in a country of Canada's size in which expertise must, of necessity, be spread thinly over a number of areas. The appointment of provincial administrators as part-time commissioners will not only accomplish these ends but is also likely to increase the degree of cooperation between the Canadian Commission and its provincial counterparts and to ensure that local needs are considered.

Several statutes authorize appointment of commissioners by the Governor in Council (the Cabinet) on the recommendation of the minister to whom the commission in question is responsible. Subsection (1), however, follows the more recent federal source provisions in making the Governor in Council alone responsible for appointments. Nevertheless, it is expected that the Minister through whom the Commission reports to Parliament will have substantial influence on such decisions.

Similarly subsections (2) and (3) follow recent federal legislation in establishing commissioners' terms and maximum age and in permitting removal for cause.¹⁰ The federal source provisions have generally been adhered to unless there is substantial reason to depart from them.

The Draft Act does not specify the qualifications of commissioners so that the Cabinet may have flexibility in making appointments to the Commission. Nevertheless, given that the Commission's duties under the Draft Act involve adjudications and interpretation of the Draft Act itself, it is expected that the majority of commissioners will have a legal background, preferably in the corporate-securities and administrative law areas. However, the Commission should not consist exclusively of members of the legal

9 Cf. Telecommunications Act, s. 15(1) (nine full-time and ten part-time commissioners).

10 See e.g. Canadian Radio-television and Telecommunications Commission Act, s. 3; but cf. Telecommunications Act, s. 15(4) (65 years).

profession. Its duties and policy-making functions under the Draft Act require an understanding of accounting principles and practice and of the functioning of the securities market, especially in relation to questions of competition policy. It would therefore be advisable to include an accountant and an economist, preferably with a securities market or business orientation, possibly as full-time commissioners, so that Commission decision-making may have the benefit of their viewpoints.

Section 15.02

There is little that needs to be said about section 15.02. It merely requires the appointment of a Chairman and Vice-Chairman of the Commission by the Governor in Council and specifies their functions. Subsection (2) follows the Anti-dumping Act and the *ALI Code* more closely than the other source provisions by specifying the powers of the Chairman and especially his power to assign work among the other commissioners.

The Ontario provisions permit the Commission to allocate the Chairman's functions to another commissioner if the Chairman cannot perform his duties for any reason. The Draft Act, however, follows recent federal legislation and declares that the Vice-Chairman replaces the Chairman in such circumstances and that a full-time commissioner does so if both are absent. It goes without saying that incapacity of a commissioner includes legal as well as physical incapacity.

Section 15.03

Section 15.03 precludes a person who has an interest in the securities business from being appointed or acting as a commissioner. It follows the approach of the more recent source provision but has been modified to apply to interests in the securities rather than the telecommunications industry. Conflicts of interest resulting from an interest in a business that competes with securities firms are not likely to be as pervasive as those prohibited by this section. Therefore they, as well as interests arising out of the ownership of securities of issuers not engaged in the securities business, are left to be dealt with by regulations made by the Commission under subsection 15.14(3).

Sections 15.04 and 15.05

Sections 15.04 and 15.05 follow in substance the source provisions in the most recent federal legislation establishing a regulato-

ry commission. The Commission may enact the rules governing the travel and living expenses of commissioners and the fees to be paid to part-time commissioners. Part-time commissioners, however, will not participate in a decision that establishes their fee, for such conduct will undoubtedly be prohibited by rules regarding conflicts of interest under subsection 15.14(3). And rules relating to either matter cannot take effect without the approval of the Minister pursuant to subsection 15.13(2).

Sections 15.06 and 15.07

The Draft Act attempts to provide a comprehensive basis for regulation of the Canadian securities market within Parliament's jurisdiction while leaving the maximum amount of flexibility for federal-provincial cooperation in the regulatory structure and exercise of the powers granted under it.¹¹ Accordingly it may be administered by a single federal regulatory agency or by a cooperative body developed through negotiations among the federal and provincial governments and agreed upon pursuant to section 15.06. Between these two poles a multitude of possibilities exist. For example, some provinces may wish to enter cooperative agreements while others may not, and some may wish to cooperate only in connection with the exercise of specific powers.¹² Sections 15.06 and 15.07 contemplate and permit all of these possibilities.¹³

Indeed, even if enacted alone, the Draft Act is not intended to and would not displace the provincial legislation. Although some of its parts, such as parts 9 and 10, are incompatible with continuing regulation under the provincial acts and therefore likely paramount, the Draft Act does not apply to intraprovincial transactions, businesses or distributions.¹⁴ In fact, it contains provisions giving priority to the decisions of provincial commissions within their own province.¹⁵ And it will still be open to the provinces to impose more stringent disclosure requirements than those under the Draft Act, to license local offices and salesmen of securities firms, even if registered under part 8, and to impose requirements relating to securities or distributions that are exempt under parts 3 and 6.¹⁶

Sections 15.06 and 15.07 thus permit the maximum amount of flexibility to the provincial and federal governments in determin-

11 See, *Howard* following n. 204.

12 See *id.* chs. VI-VII, for a discussion of the most likely variations.

13 See also section 15.09 and Commentary.

14 See sections 6.05, 8.07, 9.01, 16.01 and Commentary.

15 See sections 5.10, 8.03 and Commentary.

16 See, *Anisman & Hogg*, ch. III.H.

ing their administrative arrangements. They derive from the most recent federal legislation dealing with federal-provincial relations in an analogous regulatory area and leave open the possibility of all of the models discussed in *Howard*, including one consisting of an integrated regulatory structure presided over by a council of ministers.¹⁷ In fact, section 15.06, by permitting the delegation of the Commission's functions to a provincial commission and authorizing the Commission to accept such a delegation in respect of a provincial securities act pursuant to an agreement negotiated and entered into by the Minister, provides a framework that is well suited for the development of such a regulatory structure. And section 15.07 complements it by requiring the Commission, when so directed by the Cabinet, to invite a provincial body to appoint persons to serve as commissioners whether or not an agreement has been made pursuant to section 15.06. However, as the implications of a securities law are less broad than those of the Telecommunications Act, the power to modify the act in an agreement is not included in subsection 15.06(2).¹⁸

In short, the sections have been devised to accommodate the results of any negotiations that occur. For this reason, section 15.07 is broader than the source provision in that it permits a provincial administrator to be invited to participate in any type of Commission decision-making. (The source provision, the Telecommunications Act, s. 27(6), applies only to public hearings and in particular to those regarding broadcasting licenses.) Although some provincial administrators are likely to be appointed part-time commissioners and although section 15.12 encourages the Commission to cooperate in its decision-making with provincial administrators, this section enables the Cabinet to ensure that provincial views and interests are represented in Commission proceedings.

Section 15.08

Securities law is a specialized area and requires an understanding of the functioning of the securities market as well as legal ability. Consequently the Commission will have to develop expertise in the administration and application of the Draft Act among its own staff. It is therefore essential that it be able to hire its own legal staff who will be responsible to it. To make the Commission's power to do so clear, section 15.08 expressly authorizes the practice now followed by federal agencies such as the

17 See, *Howard*, ch. VI; and see *id.* at n. 210 and following.

18 Compare Telecommunications Act, s. 7(3).

Canadian Radio-television and Telecommunications Commission and the National Energy Board without express statutory authorization.

The section also authorizes the Commission to retain outside counsel, if necessary. It thus in effect abrogates for this purpose the Government Contract Regulations, enacted pursuant to section 34 of the Financial Administration Act,¹⁹ which permit only the Department of Justice to enter contracts for legal services.²⁰ If outside counsel are to be responsive to the Commission's needs, they must be retained by and responsible to the Commission itself.

Related to the Commission's need to exercise control over its counsel, and even more important, is the Commission's ability to control its own litigation. Criminal prosecutions under the Draft Act will require detailed knowledge of techniques of manipulation and the workings of the securities market. And the Commission's duties under the Draft Act entail the furtherance of the policies embodied in it by means of civil enforcement actions and by civil actions on behalf of persons who have been harmed by its breach.²¹ It is essential, therefore, that the Commission have control over its involvement in litigation under the Draft Act.²² Although it is expected that the Commission will frequently retain lawyers employed by the Department of Justice, they, as well as outside counsel retained by the Commission, will be subject to Commission supervision in the conduct of litigation without coming into conflict with the power of the department "to have the regulation and conduct of all litigation for or against the Crown".²³ Section 15.08 thus makes clear that litigation by, for or against the Commission is subject to the Commission's control.

Section 15.09

Section 15.09 authorizes the Commission to delegate the exercise of its powers under the Draft Act to a commissioner, to an employee or administrative unit of the Commission or to employees of other government agencies. The section is somewhat broader than the provincial source provisions which permit the delegation of any commission function to a commissioner and the delegation of all but a few specified functions to the Director of the

19 R.S.C. 1970, c. F-10.

20 See Government Contract Regulations, SOR/75-530, s. 4.

21 See *e.g.* section 14.08.

22 Cf. FEDERAL ENERGY ADMINISTRATION, TASK FORCE ON COMPLIANCE AND ENFORCEMENT, 2 FINAL REPORT xxii-xxviii, V-124-36 (Stanley Sporkin, Chairman, 1977).

23 Department of Justice Act, R.S.C. 1970, c. J-2, s. 5(d).

Commission.²⁴ (In fact the new Ontario act goes further than the present one which does not permit the Commission's power to order an investigation or issue a freeze order to be delegated even to a member of the Commission.)

The Commission's powers of delegation under section 15.09 are broad and may be exercised by order or rule. Consequently, although the powers to administer the provisions of the Draft Act are given to the Commission in specific terms, the section provides the flexibility necessary for the Commission to deal with the broad variety of powers exercisable by it. Thus, the Commission may delegate to a commissioner or to the head of one of its administrative units the power to make specific types of orders, presumably those relating to the part of the Draft Act for which the unit in question is responsible. For example, the head of the disclosure division of the Commission might be authorized to grant exemptions from the disclosure requirements. Similarly, the Commission might delegate the power to hold initial hearings to a specified hearing officer or to the director of another of its administrative divisions. (In Ontario such powers are generally delegated to the Director or Deputy Director of the Commission.²⁵) In short, the Commission will have the flexibility to make delegations in the light of the administrative structure that it adopts when it is established.

In a regulatory agency such as the Commission envisaged in the Draft Act some mixing of functions is probably inevitable and may also be beneficial by providing the Commission with several methods of gaining experience and with a number of perspectives that may be reflected in its policy-making functions under the Draft Act. Nevertheless, not all functions can be performed together without affecting other interests. For example, mixing of prosecutorial or investigative and adjudicative functions may cause some apprehension about and may in fact impede a fair hearing. Consequently, the creation of a statutory office of Commission counsel (or director of enforcement) was suggested in order to make clear that enforcement decisions, including representation of the Commission before the courts, are separate from the Commission's adjudicative functions. However, as such a statutory position would be immune from Commission oversight and control, it was not included in the Draft Act. The Commission itself should have the power and the responsibility to set enforcement as

24 See e.g. Ontario Securities Act, 1978, ss. 3(2), 6.

25 See e.g. Ontario Securities Act, s. 4; cf. CFTC, *Delegation of Authority to Dispose of Procedural Motions to Chief of Opinions Section*, CCH COMMODITY FUTURES L. REP. ¶ 20,455 (August 1, 1977) (adopting 17 C.F.R. s. 140.71).

well as other priorities and to allocate its financial resources in the administration of the Draft Act.

Instead, subsection 15.09(2) focuses on the decisions in which the separation of such functions is important, namely, those that may derive from an investigation or other enforcement activity and that may involve the imposition of a sanction, and ensures the independence of any person delegated to make an initial decision. Similarly, subsection (3) prohibits a commissioner who makes an initial decision from sitting on any hearing that follows from the initial order, thus ensuring that the commissioners who sit on an adjudicative proceeding will not have been involved in earlier decisions relating to it, for example, in making an order to initiate proceedings based on a report resulting from an investigation.²⁶

It is expected that the Commission will generally, once it has acquired some experience and established an administrative structure, exercise its powers of delegation by rule and that the importance of the power delegated will be reflected in the delegation. The Commission's powers of enforcement under part 14 of the Draft Act, for example, may have important consequences both for the implementation of the act's policy and for the persons affected by Commission action. Thus it is unlikely that the Commission would delegate its power to order an investigation under section 14.01 or 14.02, to issue a cease trading order under section 14.04 or to make a freeze order under section 14.05 to anyone other than a commissioner. Similarly, the Commission can be expected to develop its own internal procedures for the authorization of an application to a court under sections 14.06 and 14.07, of litigation, an intervention or an appearance under section 14.08 and of criminal prosecutions for a violation of the Draft Act. All of these matters may be dealt with under section 15.09.

The power to order an investigation under section 14.01 merits special attention. It is expected that the Commission will not itself appoint a person to conduct an investigation but rather will delegate the power to do so to one or several commissioners, who, as a result of subsection (3), will not be entitled to sit on any proceedings that result from an investigation initiated by them. (The Ontario act authorizes the Commission alone to appoint a person to conduct an investigation. The new Ontario act, however, permits delegation of the power to appoint an investigator to a member of the Commission but not to the Director.²⁷)

Subsection 15.09(1) makes clear that the Commission may,

26 Cf. Ontario Securities Act, 1978, s. 3(3).

27 See Ontario Securities Act, ss. 3(2), 21; Ontario Securities Act, 1978, ss. 3(2), 6, 11.

where appropriate, delegate its functions to persons outside of the Commission, but only to persons employed by other government agencies. Thus where it believes that it is advantageous to do so, the Commission may delegate a specific power to a member of a provincial securities commission or, where international cooperation is required, to a commissioner or employee of a foreign securities commission.²⁸

Finally, subsection (3), as mentioned above, prohibits a commissioner who makes an order as a delegate of the Commission from sitting on a hearing to review his initial decision.²⁹ The Draft Act is slightly broader than the Ontario Securities Act, 1978, s. 3, from which it derives, in that it applies to all proceedings that follow from a commissioner's order and not only to those flowing directly from it.³⁰

Section 15.10

The Commission's functions under the Draft Act require knowledge of a wide variety of specialties. The vetting of a prospectus under part 5 may involve, for example, detailed knowledge of accounting principles and of the industry in which the issuer operates as well as of less general disciplines such as geology or engineering. Although it is expected that the Commission will hire people with expertise in these areas as part of its staff, situations may arise in which expert advice is required but is not available within the Commission. In such circumstances it will be necessary for the Commission to retain an expert and section 15.10 authorizes it to do so.

Section 15.10 is broader than the source provisions in that it permits the Commission to "appoint an expert to assist it in any manner...it considers necessary". The Ontario legislation expressly authorizes the Commission to submit any filing or other document to an expert, to summon witnesses to appear before him and to have him participate in an investigation.³¹ Similar provisions are not included in the Draft Act because section 15.10 is itself sufficiently broad to include them. In effect, it extends the Commission's power to delegate to experts who are not government employees and who are, therefore, not included within section 15.09.

While the power to appoint is broad enough to include the use

28 See also sections 15.06, 15.07, Commentary.

29 Cf. *R. v. Alberta Securities Commission, Ex parte Albrecht*, 38 W.W.R. (n.s.) 430, 36 D.L.R. (2d) 199 (Alta. S.C. 1962); see also J. WILLIAMSON at 263-64.

30 Cf. Ontario Securities Act, 1978, s. 3(3).

31 See e.g. Ontario Securities Act, 1978, ss. 5(2), 11(8).

of experts to aid in the making of adjudicative orders, it is expected that the Commission will require such experts to give evidence in such proceedings and, possibly, to appear as witnesses where specific material facts are in issue, in order to ensure that all parties have an opportunity to comment upon their expert "advice". Such a procedure would be fairer in judicial proceedings than the receipt of expert advice by the Commission off the record.

The section may be utilized as well in other than adjudicative or investigative proceedings. In devising or implementing policy guidelines or regulations the Commission may wish to obtain the advice of persons with expertise in the area under consideration who may not be in a position to undertake employment of any type with the Commission. For example, the advice of corporate executives and practising accountants may be valuable to the Commission in making regulations implementing the disclosure requirements of the Draft Act, but such persons may be unwilling to work for the Commission on either a full- or part-time basis because of their professional commitments (including possible conflicts of interest). Section 15.10 permits the Commission to avail itself of their knowledge and to obtain their advice by establishing an advisory board and appointing them to it.

Although the Ontario legislation and the *ALI Code* contain special provisions dealing with advisory boards, the Draft Act treats such bodies as groups of experts that may be appointed for a specific purpose by the Commission under the general power in section 15.10.³² Thus the Commission may obtain considered advice on specific areas within its jurisdiction from persons with valuable knowledge and experience, which would otherwise be unavailable to it except in an "interested" forum, that is, in investigative proceedings under section 14.02 or pursuant to the rule-making procedure.³³

As recommendations of such experts are likely to exert an influence on the Commission's determination of policy, subsection (2) requires that they be submitted to the Commission in a written report and made public. Some consideration was initially given to establishing a formal procedure for advisory boards, including a requirement that their proceedings be open and that interested persons be provided an opportunity to make representations like that required by the United States Federal Advisory Committee

32 Cf. Ontario Securities Act, 1978, s. 4 (Financial Disclosure Advisory Board); ALI FEDERAL SECURITIES CODE, s. 1003(b). The *ALI Code* omits any reference to the National Market Advisory Board established pursuant to the Securities Exchange Act of 1934, s. 11A(d)(1); see *id.* s. 1003(b), note.

33 See e.g. ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION (1977).

Act.³⁴ However, it was concluded that such a formal structure for advisory boards is premature in Canada and only the requirements included in subsection (2) have been retained. The section thus permits the Commission the flexibility to feel its way in light of its developing needs.

The Ontario legislation specifies that experts appointed by the Commission shall be paid and receive expenses in accordance with the Cabinet's determination but that members of the Financial Disclosure Advisory Board shall serve without remuneration. (The Cabinet may fix a *per diem* allowance and members are entitled to recover "reasonable and necessary expenses".) The Draft Act does not include similar provisions so that the Commission must retain experts in accordance with the normal rules governing service contracts with government agencies. Presumably, however, experts retained to serve on a policy advisory board will treat their service as a public function and will receive only nominal, if any, remuneration.

Section 15.11

Section 15.11 requires the Commission to prepare and publish an annual report describing its activities during the preceding fiscal year. Subsection (1) follows the Canadian source provisions and requires that the Commission send its annual report to the Minister with responsibility under the act who must table it in Parliament. As with other similar regulatory statutes, the Commission thus reports to Parliament through a designated Minister. Subsection (2) is new; it reinforces the usual publication requirement that an annual report be tabled in Parliament by requiring that copies of the report be made available to the public fifteen days after it is sent to the Minister, so that it will be released after it is sent to the Minister whether or not there is a delay in its tabling because Parliament is not sitting.

Section 15.11 essentially follows the Canadian federal models supplemented by specification of the type of information that must be included in the report.³⁵ Although the provincial securities acts do not require an annual report to be made by the commissions, data on their annual volume of work is published by several provincial commissions. The work of the Ontario Securities

34 P.L. 92-463, 86 Stat. 770 (1972); for an analysis of the act's effectiveness, see Committee on Government Operations, Subcommittee on Reports, Accounting and Management, *Hearing on S. 2947 and S. 3013 to Amend the Federal Advisory Committee Act - P.L. 92-463* (1976); cf. Hills, *Oversight and Review of Agency Decisionmaking*, 28 ADMIN. L. REV. 577, 578 (1976) (panel discussion).

35 See subsection (3).

Commission, for example, is included in the annual report of the Department of Financial and Commercial Affairs.³⁶ The Alberta Securities Commission publishes a similar report in its monthly summary and the British Columbia Corporate and Financial Services Commission does the same in its Weekly Summary.³⁷

The specification of contents for the annual report, the major difference between section 15.11 and the Canadian source provisions, should help to provide more effective oversight of the Commission's performance.³⁸ Subsection (3) requires in essence that an annual report include a statement of the Commission's goals and priorities in relation to the development of standards (regulations) and its enforcement activities in order to encourage it to consciously engage in planning and to integrate its planning functions with the preparation of its annual budget.³⁹ It must include as well information on the Commission's activities during the year under each Part of the Draft Act so that the volume of the Commission's workload and the scope of activity in the Canadian securities market will be clear. The historical information required is largely statistical and will usually be presented in summary or tabular form.

Some of the provisions, such as paragraphs (3)(c), (d) and (e), also require the Commission to provide an overview of the major reasons for its decisions. Their purpose, however, is not to force the Commission to give detailed reasons in its annual report for each decision taken during the year; such reasons will be given elsewhere.⁴⁰ Rather they are intended to encourage the Commission to consider its experience on an annual basis. This kind of evaluation is emphasized with respect to regulations by paragraph (3)(h) which requires the Commission to include in its report the results of any monitoring activities it has undertaken during the year to determine the impact of its regulations.⁴¹

It would be surprising if the Commission as a result of its day-to-day administration does not discover deficiencies in the Draft Act that require its amendment. Any recommendations made by the Commission for new or amending legislation must

36 See e.g. ONTARIO, DEPARTMENT OF FINANCIAL AND COMMERCIAL AFFAIRS, ANNUAL REPORTS (1968-1972).

37 See e.g. Alberta Securities Commission Summary, November 30, 1976, at 1-2; B.C. Corporate and Financial Services Division Weekly Summary, December 19, 1975. See also Annual Reports of the Securities and Exchange Commission.

38 See, *Howard* following n. 107; cf. e.g. SECRETARY OF STATE, LEGISLATION ON PUBLIC ACCESS TO GOVERNMENT DOCUMENTS 22 (Green Paper, June 1977).

39 Cf. COMMITTEE ON GOVERNMENTAL AFFAIRS, UNITED STATES SENATE, 4 STUDY ON FEDERAL REGULATION: DELAY IN THE REGULATORY PROCESS 153-57 (1977).

40 See sections 15.15, 15.17.

41 Cf. ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION D-12, D-34 (1977).

also be included in the annual report.⁴² They will thus receive a public airing and ensure public discussion, often while they are in the process of formulation, so that comments from all interested parties may be received by the Commission even before a bill is prepared and introduced in Parliament. This type of opening of the legislative process should help to improve the quality of legislation.⁴³

The annual report is not intended to be the only vehicle by means of which the Commission communicates information about its activities to either the Minister or the public. Rather it is intended to ensure that the Commission gathers and reflects on its accumulated experience at least on an annual basis. It is expected as well that the Commission will have an ongoing relationship with the Minister through whom it is responsible, especially in relation to the adoption of regulations which are subject to either ministerial or Cabinet approval. Moreover, as the Minister will be responsible to respond to questions in Parliament concerning the Commission, he is likely to require information about the Commission's activities on a regular basis. Subsection (4) therefore merely formalizes in the Draft Act the practice that would develop in any event and by doing so emphasizes that the Commission, albeit a quasi-independent agency, must operate within the context of the parliamentary system.

Subsection (5) complements the other provisions of section 15.11 by requiring the Commission to publish on a regular basis information concerning its activities. The information included in the regular periodical should be more detailed than that in the annual report in order to provide interested persons with continuing information on the Commission's decisions and rulings. Several of the provincial securities commissions (British Columbia, Ontario and Quebec) now publish weekly summaries that list the applications and filings received by them. Draft policy statements are published in them for comment prior to adoption. (The Alberta Commission publishes similar information in a monthly statement.) The Ontario Commission also publishes a monthly bulletin that contains the reasons for its decisions and draft and final policy statements. And the Corporations Branch of Consumer and Corporate Affairs Canada publishes a monthly bulletin containing similar information and also includes in it proposed regulations under the Canada Business Corporations Act. It is expected that the Canadian Securities Commission will adopt a similar practice and will publish both a weekly and monthly bulletin in which it will

42 See paragraph (3)(j).

43 Cf. section 15.15 specifying a public rule-making procedure.

include data concerning its activities and proposed rules. In fact, it may also wish to publish a daily summary of filings and other proceedings.⁴⁴

Under subsection (5) a regular periodical is mandatory but the frequency of publication is left to the Commission's discretion. The Commission may, in fact, publish several such periodicals and would likely do so even if the subsection were not included. The requirement is included not only to ensure that it does so but also to reinforce the openness in the Commission's procedures that is fundamental to the administrative scheme of the Draft Act.

Section 15.12

Section 15.12 deals with the Commission's relations with other government agencies performing related functions. Subsections (1) and (2) are largely hortatory and are intended to encourage the Commission to cooperate with provincial securities commissions and other agencies, both federal and provincial, which regulate financial institutions that may be exempt from the disclosure requirements of the Draft Act.

The Draft Act contemplates that the Commission will have contact with its provincial counterparts in a number of ways. Provincial commissioners may be appointed to the Commission; the administration of parts of the Draft Act may be delegated to a provincial commission, either individually or as part of a national cooperative scheme, and the Commission itself may appoint members or employees of provincial commissions as its delegates.⁴⁵ Subsection (1) rounds out the scheme by encouraging cooperation generally to maximize investor protection with as little duplication of effort as possible, and it is expected that a spirit of cooperative effort will pervade the Commission's activities whatever the regulatory structure ultimately adopted for the Canadian securities market.

Financial institutions are exempt from the disclosure requirements of the Draft Act only if they are subject to the supervision of a government agency and must disclose to the public information substantially similar to that required under the Draft Act.⁴⁶ The Commission must therefore make a preliminary determination whether the disclosure requirements applicable to a particular financial institution are sufficiently similar to those of the Draft Act to bring it within the exempted class, and even then the

44 See e.g. the SEC Digest.

45 See sections 5.06, 5.07, Commentary.

46 See paragraph 3.02(1)(c).

Commission retains a residual discretion to deny the exemptions to a particular financial institution or generally where there is reason to do so.⁴⁷ Consequently, there are several areas in which the Commission's jurisdiction over a regulated financial institution under the Draft Act may intersect with that of the agency that exercises regulatory authority over it. It is desirable that the various agencies cooperate to ensure that all issuers whose securities are publicly traded are subject to the same disclosure rules for the protection of investors.

Subsection (2) requires cooperation in order to avoid duplication of reporting requirements and enforcement efforts. It is expected that the consultation and cooperation mandated by the provision will take place in relation to all of the relevant activities of the Commission. For example, the Commission should consult with the relevant regulatory authorities when preparing proposed regulations, for such consultation is more likely to ensure uniformity of disclosure requirements. Similarly, the agencies should cooperate in enforcement proceedings, insofar as it is practicable to do so, by coordinating their investigations of a particular institution or at least by providing early notice to each other of apprehended violations and of the results of investigations.

Unlike subsections (1) and (2), subsections (3) and (4) are not hortatory. Rather they authorize the Commission to cooperate with the agencies of foreign governments in the detection of international fraudulent schemes involving securities and to participate in international proceedings relating to the regulation of securities markets. In light of the increasing ease of international communication and the increasing internationalization of the securities markets themselves, such powers are essential. In fact, a similar provision was recently added to the Canada Business Corporations Act.⁴⁸ Thus the Commission may not only cooperate in international investigations but it may also participate in efforts to harmonize local laws in order to achieve greater uniformity of legislation on an international basis.

Section 15.13

The Draft Act gives the Commission broad powers to make regulations. Most powers of this type are granted in relation to substantive policy and are therefore included throughout the Draft Act in the Part concerning the matters to which they relate.

⁴⁷ See section 3.04.

⁴⁸ See An Act to amend the Canada Business Corporations Act, S.C. 1978, c.9, s. 73 (new subsection 224(1.1) to permit investigator to exchange information).

The rule-making provisions in this Part grant the Commission general powers with respect to matters that are applicable to the whole of the Draft Act, establish a procedure for the making of regulations (section 15.15) and provide for judicial review of the Commission's exercise of these powers (section 15.20).

Rule-making powers are essentially of three types, substantive, procedural and housekeeping.⁴⁹ Section 15.13 authorizes the Commission to make the latter two types of rules; paragraph (1)(b) authorizes the making of procedural rules and the rest of the paragraphs of subsection (1) deal with matters relating to the internal organization and practices of the Commission, that is, with "housekeeping" matters. Substantive regulations are generally authorized in the succeeding section.⁵⁰ In some instances it may be difficult to characterize a regulation as clearly procedural or substantive. However, questions arising from such characterization go to the nature of the procedure to be followed in the adoption of the regulation and are dealt with in relation to judicial review of the Commission's exercise of its rule-making powers.⁵¹

Paragraph (d) permits the Commission to establish fees to be paid to part-time commissioners for the performance of their duties and for travelling expenses despite a potential conflict of interest. It is expected, however, that the former type of rule will be enacted only by the full-time commissioners. And neither type can become effective without the approval of the Minister under subsection (2). As the source provisions indicate, a similar provision is included in recent federal legislation dealing with the same subject.⁵²

Section 15.14

Section 15.14 gives the Commission general powers to adopt regulations in relation to its administration of the Draft Act and thus specifies only the types of regulation that are applicable to all parts of the Draft Act. The Commission's regulatory powers relating to specific matters are granted in the substantive provisions of the Draft Act and there is no attempt to restate them summarily in a single section as is done in the provincial securities acts. Rather, this section authorizes the Commission to classify, to prescribe contents of filed documents, to establish standards for financial reporting and to set ethical standards of conduct for its members and employees. And paragraph (1)(d) follows the gener-

49 See e.g. P. ANISMAN, *supra* note 4, at 16-17.

50 See section 15.14 and Commentary.

51 See section 15.15(5)(b) and Commentary.

52 And cf. section 15.04, Commentary.

al approach of the Canada Business Corporations Act by authorizing the making of any other regulations authorized elsewhere in the Draft Act.

Paragraph (1)(d) also authorizes the Commission to make regulations "required to carry out" the Draft Act's purpose. This authority is included to ensure that no gaps exist in the Commission's rule-making power. Provisions of this type are common in federal legislation.⁵³

The power conferred under subsection (1) is broad. In recent years broad regulatory powers, and especially the power to define terms by regulation, have been the subject of criticism by influential commentators.⁵⁴ Nevertheless, the general power conferred by paragraph (1)(d) is included to enable the Commission to adapt its policies to the dynamic nature of the securities market.⁵⁵ The Draft Act does not, however, authorize the Commission to define its terms by regulation.⁵⁶ Although an agency that applies or enforces laws must inevitably interpret them, a power to do so in regulations would give the agency ultimate power, subject to judicial review under section 15.20, to determine the meaning of its statute and thereby the scope of its jurisdiction. The Draft Act leaves this determination where it has been traditionally, with the courts. Nevertheless, given the desirability of consistent application of the Draft Act, it is expected that the Commission will follow the present practice of its provincial counterparts and utilize policy statements to indicate its view of the statute's application.

Although the Commission may initiate regulations, it must in doing so follow the open rule-making procedure under section 15.15 and must obtain the approval of the Governor in Council before a regulation becomes effective. And the regulation is then subject to review by the Joint Committee on Statutory Instruments. Perhaps more important, any regulation adopted by the Commission is subject to judicial review, not only on the basis of whether it is authorized by the Draft Act, that is, on the question of *ultra vires*, but also on the basis of its reasonableness.⁵⁷ The courts therefore retain under the Draft Act their residual discretion to ensure that the Commission does not adopt, even by regulation, interpretations of the Draft Act that are arbitrary or capricious. Thus the procedural and review provisions of the Draft Act

53 See e.g. P. ANISMAN, *supra* note 4, table IV, col. 3.

54 See e.g. 1 ROYAL COMMISSION INQUIRY INTO CIVIL RIGHTS 356, 358 (1968); SPECIAL COMMITTEE ON STATUTORY INSTRUMENTS, THIRD REPORT, in VOTES AND PROCEEDINGS OF THE HOUSE OF COMMONS, No. 198, October 22, 1969, 1411 at 1444-46, 1450-51.

55 See e.g. part 10, Commentary; cf. RENTON REPORT at 442-43; *Grover & Baillie* at n. 300.

56 Cf. ALI FEDERAL SECURITIES CODE, s. 1804(a)(1).

57 See paragraph 15.20(5)(a).

provide a reasonable check on the broad powers of the Commission to adopt regulations.

The common regulatory powers in paragraphs (1)(a) and (b) may in their application be no less broad than those just discussed. For example, as "person" is an inclusive term the Commission may, under paragraph (1)(a), classify issuers for purposes of parts 4, 5 and 7 and prescribe differential disclosure requirements, or it may achieve similar results by classifying "filings" on the basis of the person submitting them. Similarly, it may prescribe special requirements for foreign registrants or applicants for registration under part 8. In short, paragraph (1)(a) is sufficiently broad to authorize classification of any person or thing subject to the Commission's jurisdiction and provides a further example of the utility of the procedural and review provisions of this Part.

Although subsection (2) gives the Commission rule-making authority in relation to a specific area, namely, the preparation and auditing of financial statements, its subject matter is applicable to all parts of the Draft Act. The section deals, in effect, with three subjects, the form and content of financial statements, accounting standards relating to the preparation and examination of financial statements, and the audit and independence of auditors. Although regulations concerning all of the matters covered in the subsection might have been promulgated under a broad interpretation of paragraph (1)(b), their express inclusion makes the Commission's authority over the accounting conventions used in filed documents clear. As a result, paragraph 15.14(1)(b) is by implication limited to the form and content of filings and applications except for the financial statements contained in them. (But the positioning or incorporation by reference of financial statements in a filing remains within the scope of the paragraph.)

The question of who should establish accounting standards has for some time been a matter of controversy. It is arguable, for example, that as accounting principles ultimately determine the standards of financial disclosure under securities laws, they should be made by a body responsible to the legislature rather than a self-regulating professional body.⁵⁸ However, although the provincial securities acts and the Canada Business Corporations Act authorize regulations prescribing such standards, as the source provisions indicate, the establishment of accounting standards has generally been subdelegated to the profession in Canada.⁵⁹

58 See e.g. Kripke, *Is Fair Value Accounting the Solution?*, 26 BUS. LAW. 289 (1970).

59 See e.g. Canada Business Corporations Regulations, s. 44 (adopts *CICA Handbook*); Canadian Securities Administrators, National Policy No. 27, 2 CCH CAN. SEC. L.

Nevertheless, the regulatory bodies do exercise some independent powers. Negotiations are conducted with the Canadian Institute of Chartered Accountants and the Ontario Securities Act establishes a Financial Disclosure Advisory Board to provide the Ontario Commission with advice in relation to accounting principles.

Subsection (4) enables the Commission to follow the present practice in connection with accounting requirements and extends the same powers to the by-laws of self-regulatory organizations. The provision was included after a discussion among the advisers which reflected a substantial diversity of views about the propriety of authorizing the Commission so to subdelegate but which resulted in a conclusion favouring its retention. Some misgivings derived from the fact that the exercise of the power under subsection (4) would give the *CICA Handbook*, for example, the force of law rather than leaving it as a set of recommendations that the Commission generally finds acceptable as a matter of policy.⁶⁰

Subsection (4) derives from experience with the regulations relating to financial statements under the Canada Business Corporations Act. Initially an attempt was made to draft a comprehensive set of regulations to govern the preparation of financial statements under the act. However, although the draft attempted to duplicate the recommendations in the *CICA Handbook*, the changes necessary to embody the accounting principles in legislative language frequently resulted in unintended changes in principle. In result, the attempt was abandoned, the recommendations in the *Handbook* were adopted by reference⁶¹ and the Canada Business Corporations Act was amended to authorize the Governor in Council to subdelegate to the Canadian Institute of Chartered Accountants in order to avoid the need to amend the Regulations every time the *Handbook* is changed.⁶² Subsection (4) is necessary if the same principle is to be followed in the Draft Act.⁶³ The subsection makes clear, however, that the Commission must follow the procedure in section 15.15 if it desires to exercise its powers to subdelegate. And presumably the representations permitted in such circumstances would include discussion of specific by-laws of the self-regulatory organization in question as well as the general advisability of a proposed subdelegation.

REP. ¶ 54,864 (adopted December 7, 1972; "generally accepted accounting principles" those in *CICA Handbook*).

60 Cf. *id.* (National Policy No. 27).

61 See Canada Business Corporations Regulations, s. 44.

62 See An Act to amend the Canada Business Corporations Act, S.C. 1978, c. 9, s. 81 (adding new paragraph 254(1)(e)).

63 See also STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE, PROCEEDINGS, Issue No. 8, November 30, 1977, at 22-31.

Whether or not the Commission exercises its powers under subsection (4), it may still utilize those under subsection (2) to deal with specific accounting principles which require modification. Thus subsection (2), while in form substantially the same as the present Canadian legislation, provides the Commission with a residual regulatory power over financial statements required under the Draft Act. In effect, therefore, the Commission may deal with accounting standards in much the same manner as it deals with the by-laws of a self-regulatory organization. In brief, the Canadian Institute of Chartered Accountants is a self-regulatory body that establishes rules for the preparation of financial statements that govern its members. The Commission is responsible under the Draft Act to ensure that financial statements are prepared in a manner that fairly discloses material information to investors, and it may do so by making regulations with respect to financial reporting in filed documents. Whether or not the Commission exercises its powers under subsection (4), regulations adopted under subsection (2) to deal with a specific matter, like those under the provincial securities acts, prevail over the *Handbook*. It is likely, however, that the Commission will play a supervisory role over the establishment of accounting standards by the profession and will move and be encouraged to move primarily to fill gaps left by the self-regulators.

The Commission's rule-making powers under the subsection also relate to the auditing of financial statements. The Commission may by regulation require audits by independent accountants, establish standards for independence and determine the nature of the audit itself by prescribing the contents of the auditor's report. The present legislation in Canada on these matters varies. The provincial legislation authorizes regulations no less broad than those authorized by the Draft Act.⁶⁴ The Canada Business Corporations Act, however, authorizes regulations relating to accounting requirements for financial statements but itself specifies the standards for independence of auditors.⁶⁵ While it is expected that the Commission would adopt standards similar to those in the Canada Business Corporations Act, all of these matters are left to regulations in order to provide it with flexibility to adapt the standards to different contexts.

It is expected that the Commission will exercise supervisory powers over the profession's standards for audits in the same manner as over accounting standards. One example should suffice. The Canada Corporations Act, the predecessor of the Canada

64 See e.g. Ontario Securities Act, s. 147(h).

65 See Canada Business Corporations Act, s. 155.

Business Corporations Act, requires an auditor to certify that financial statements present *fairly* the financial position and results of the corporation's activities in accordance with generally accepted accounting principles.⁶⁶ It is arguable that the section imposes a dual standard, namely, that the financial statements present the requisite information fairly *and* that they be prepared in accordance with generally accepted principles.⁶⁷ However, the interpretation of the provision is not clear. The Canada Business Corporations Act, as mentioned above, merely adopts the provisions of the *CICA Handbook*. And the *Handbook* was recently amended to remove any implication that an auditor attests to the fairness of the reported results in financial statements that he certifies. The Commission may wish to give priority to this matter in relation to its powers under paragraph (2)(e).

Subsection (3) completes the Draft Act's scheme for preventing conflicts of interest and other improper practices by authorizing the Commission to enact a code of conduct for its members and employees.⁶⁸ It is expected that the Commission's code of conduct, promulgated under this section, will deal with matters such as the ownership of and trading in securities by its employees, possibly even specifying the types of investment permissible for them. The catchall provision permits the Commission to deal by regulation with practices that may not involve a conflict of interest but that it nonetheless may consider undesirable and is included in order to allow it the flexibility to deal with unforeseen matters, including perhaps such minor matters as the nature of the disclaimer in publications by its employees.⁶⁹ The Commission might also, for example, prohibit former employees from appearing before it for a specified period after the cessation of employment.⁷⁰

Subsection (3) authorizes rules that may overlap with the conflict of interest guidelines adopted for federal public servants, as well as rules that extend beyond them. It is expected that the Commission's rules will be consistent with the guidelines, but

66 Canada Corporations Act, s. 132(2).

67 See e.g. P. ANISMAN at 229 n. 417; cf. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 188-95 (1976).

68 See also subsection 15.01(4) (full-time commissioner must devote all professional time to performance of duties), section 15.03 (commissioner may not engage in securities business or have pecuniary or other interest in securities firm or self-regulatory organization) and section 15.23 (improper disclosure or use of confidential information by commissioner or commission employee or tippee prohibited).

69 Cf. generally ROYAL COMMISSION ON STANDARDS OF CONDUCT IN PUBLIC LIFE 1974-76, REPORT, Cmnd. 6524, ¶¶ 210-26 (1976).

70 Cf. *id.* ¶¶ 199-209; COMMITTEE ON INTERGOVERNMENTAL AFFAIRS, UNITED STATES SENATE, PUBLIC OFFICIALS INTEGRITY ACT OF 1977, REPORT TO ACCOMPANY S. 555, 31-34, 47-49, 151-54 (1977).

because of the sensitivity of the area regulated by it, the Draft Act does not limit the Commission's discretion in this regard.

Although the "code of ethics" to be adopted under the section is a matter of internal organization or practice of the Commission, it is made mandatory (as well as subject to the procedure for regulations and Governor in Council approval) because the matters to be covered by it are sufficiently serious that they should not be left exclusively to the Commission's discretion lest they be set aside in order to deal with substantive regulations which the Commission might view as more urgent.⁷¹

Section 15.15

Rule-making by public authorities subordinate to Parliament has become a common feature of modern government.⁷² One leading commentator has gone so far as to characterize rule-making as "the main tool for getting governmental jobs done",⁷³ and a recent congressional study has recommended it as a major method of avoiding unnecessary delay in administrative decision-making.⁷⁴ Given the increasing complexity of modern society and the increasing burden imposed on legislators as well as the technical nature of much legislation this development was probably inevitable.⁷⁵ The Draft Act therefore gives the Commission broad powers to make regulations to classify persons, securities and transactions and to establish standards for disclosure and other requirements.⁷⁶

However, in exercising its rule-making powers the Commission must act openly and fairly. Section 15.15 ensures that it will do so by establishing a procedure for Commission regulations; the Commission must publish regulations that it proposes to make along with a brief statement of the reasons for the proposal and must provide interested persons an opportunity to make representations in respect of the proposed regulation for a period of at least sixty days. The section thus requires, in effect, a hearing adapted to the needs of the legislative process. The procedure derives primarily from the Administrative Procedure Act of the United States where it has been called the "greatest invention of modern

71 Cf. FEDERAL ENERGY ADMINISTRATION, TASK FORCE ON COMPLIANCE AND ENFORCEMENT, *supra* note 22, at xviii-xxi.

72 See e.g. P. ANISMAN, *supra* note 4, at 15-18, 23 (3,467 of 14,885 discretionary powers empower rulemaking; "scope of rulemaking powers is substantially broader than that of all the others combined").

73 K. DAVIS at 168.

74 See COMMITTEE ON GOVERNMENTAL AFFAIRS, UNITED STATES SENATE, 4 STUDY ON FEDERAL REGULATION: DELAY IN THE REGULATORY PROCESS 21-53 (1977).

75 See e.g. Howard at nn. 102-09.

76 See section 15.14 and Commentary.

government".⁷⁷ But it is not peculiar to the United States; the Rules Publication Act 1893⁷⁸ required a similar procedure in the United Kingdom in a limited number of cases until its repeal in 1946.⁷⁹ Substantially the same procedure is still expressly included in a few "exceptional" statutes.⁸⁰ And it has recently been suggested that the informal practice of consultation prior to the making of regulations usually followed in Britain should be made mandatory and formalized on a general basis following the U.S. pattern.⁸¹

The situation in Canada is similar to that in Britain. Although there is no general requirement that regulations be circulated for comment before they are adopted, consultation with a select group of individuals frequently occurs. And in some cases, as the two Canadian source provisions indicate, predisclosure of proposed regulations and an opportunity for interested persons to comment are statutorily required. In fact at least nine federal statutes other than the source provisions contain a similar requirement and the tendency toward its use is continuing.⁸² However, the Canadian provisions tend to be general in nature requiring little more than "a reasonable opportunity...to interested persons to make representations".⁸³

The Draft Act goes further than the typical Canadian provision and attempts to provide in some detail reasonable requirements for rule-making and for judicial supervision by means of review⁸⁴ in light of the experience under the Administrative Procedure Act in the United States where there has been a comparatively large amount of litigation on various aspects of procedure in relation to rule-making. Thus subsection (1) follows the Canada Business Corporations Act in requiring that copies of proposed regulations be published at least sixty days before they are adopted (the Administrative Procedure Act requires only thirty days and the proposed regulation itself need not be published although it usually is) and supplements it by requiring as

77 K. DAVIS, *DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY* 65 (1969).

78 56 & 57 Vict., c. 66 (1893).

79 See e.g. B. SCHWARTZ & H. WADE, *LEGAL CONTROL OF GOVERNMENT: ADMINISTRATIVE LAW IN BRITAIN AND THE UNITED STATES* 97-98 (1972).

80 See e.g. *id.* at 98; Prevention of Fraud (Investments) Act, 1958, 6 & 7 Eliz. 2, c. 45, s. 7(3) (1958).

81 See Garner, *Rule Making in the United States*, [1976] PUB. L. 307, 312.

82 See P. ANISMAN, *supra* note 4, table I, cols. 4, 6; and see e.g. Telecommunications Act, ss. 33, 61; An act to amend the National Transportation Act and the Department of Transport Act, Bill C-33, 30th Parl., 2d Sess., s. 15 (First reading January 27, 1977), amending Railway Act, c. R-2 by adding s. 278.1 (Governor in Council regulations).

83 E.g. Canada Business Corporations Act, s. 254(2).

84 See section 15.20.

well a concise statement of the substance and purpose of the proposed regulation, a reference to the provision of the Draft Act authorizing it and a statement of the time, place and manner for submission of representations. Paragraphs (1)(b) to (d) derive from the U.S. statute and provide useful information to a person wishing to comment on a proposed regulation.⁸⁵

Subsection (2) establishes the minimum procedural standards for rule-making under the Draft Act by requiring that the Commission provide a reasonable opportunity for interested persons to make representations with respect to a proposed regulation. Although the mandated hearing involves written representations rather than oral presentations, the Draft Act does not preclude the possibility of the latter in a rule-making proceeding. Rather it establishes the minimum and leaves to the Commission's discretion the determination of whether oral presentations in some form would be useful to the development of views on a particular proposal. The only limitation on the exercise of the Commission's discretion in this regard is that interested persons must be afforded "a reasonable opportunity" to make their views known. While it is conceivable that a reviewing court might consider oral argument necessary in order to meet that requirement, it is doubtful that it would second-guess the Commission in this regard, especially in light of subsection (3).

However, a court might interpret "reasonable opportunity" to require that the comment period be long enough to permit interested persons to submit representations based upon the briefs of others. Such an interpretation of the provision would ensure that interested persons may meet the other side's case within the limits of a written procedure and derives from decisions of U.S. courts supplementing the Administrative Procedure Act in order to ensure fairness.⁸⁶ Thus it may be argued that the sixty-day provision is a minimum and that the "reasonable opportunity" required by subsection (2) may supplement it in some circumstances so that the Commission, on application, might be required to extend the period to provide a reasonable opportunity to deal with unforeseen information in a comment. Nevertheless, the Commission will inevitably have to call a halt at some stage.⁸⁷ In short the question of reasonableness in a specific factual context may arise in a proceeding to review the Commission's exercise of

85 *Cf. Ethyl Corporation v. Environmental Protection Agency*, 541 F.2d 1, 48 (D.C. Cir. 1976) ("sufficiently descriptive...so that interested parties may offer informed criticisms and comments").

86 *See K. DAVIS* at 171, 179.

87 *Cf. Ethyl Corporation v. Environmental Protection Agency*, *supra* note 85, at 52.

its rule-making power. (The argument is also available under the Canadian source provisions.)

Although a written hearing, possibly supplemented by oral argument, is appropriate to policy-making, it may not be so if a specific factual determination is necessary. For such determinations a trial-type hearing involving cross-examination may be appropriate. Because issues involving specific facts may arise in a rule-making proceeding, subsection (3) gives the Commission a discretion to hold an evidentiary hearing and to permit cross examination where the issue of specific fact is material to its consideration of a proposed regulation. The subsection is based upon judicial developments in the United States imposing a requirement that agencies permit cross-examination even in a rule-making proceeding where it provides the best way of dealing with an issue of specific fact.⁸⁸ It should be stressed, however, that cross-examination in a rule-making proceeding should be the exception. Rather subsection (3) permits the Commission to devise the most appropriate procedures for bringing out the relevant issues and it may utilize any number of devices short of formal trial-type proceedings.⁸⁹ It goes without saying that the courts should not lightly interfere with the Commission's exercise of its discretion under subsection (3).

The basic purpose of section 15.15 is to ensure that the Commission follows an open, fair and rational procedure when making regulations. Subsection (4), therefore, rounds out the pattern of the section by requiring the Commission to publish a concise statement of the basis and purpose of a regulation that it adopts. The subsection will probably in most cases require little more than a general statement of the Commission's reasons for adopting a regulation in a particular form. But in some cases, for example, where the final regulation varies substantially from the initial proposal, more detailed reasons may be necessary. And in exceptional cases, even greater detail may be required by a reviewing court.⁹⁰

88 See K. DAVIS at 183-90, 217-19; see also Federal Trade Commission Improvement Act, s. 18(b). And see the procedures adopted by the Federal Trade Commission to implement it; Federal Trade Commission, *Rulemaking and Public Participation under the FTC Improvement Act* 1-6 (Staff Guidelines: Bureau of Consumer Protection, June 1977).

89 See e.g. *Natural Resources Defence Council, Inc. v. United States Nuclear Regulatory Commission*, 547 F.2d 633, 653-54 (D.C. Cir. 1976); Kestenbaum, *Rulemaking Beyond APA: Criteria for Trial-Type Procedures and the FTC Improvement Act*, 44 GEO. WASH. L. REV. 679, 702-705 (1976); cf. COMMITTEE ON GOVERNMENTAL AFFAIRS, *supra* note 74, at 41-44.

90 Cf. e.g. K. DAVIS at 172-75; *id.*, CUMULATIVE SUPPLEMENT 60-68, 216-18 (1977); and see e.g. *Natural Resources Defence Council Inc. v. United States Nuclear Regulatory Commission*, *supra* note 89, at 646.

Although the procedure prescribed in subsections (1) and (2) is generally required for Commission rule-making, there are a number of situations in which it is unnecessary and would, in fact, be unduly cumbersome. Thus the procedure applies only to "regulations" made by the Commission pursuant to powers under the Draft Act. Such regulations involve the exercise of delegated legislative power and, if valid, are binding on all persons subject to them and on the courts. But the procedure is not applicable to the exercise of all the Commission's policy-making functions. The Commission may, for example, issue a policy statement indicating its intention to administer a particular provision of the Draft Act in a specified manner or indicating its views on the interpretation of a provision of the Draft Act. Such statements are not "regulations" subject to section 15.15 and are not binding on the courts or even, in all circumstances, on the Commission itself.⁹¹ Similarly, the Commission may declare policy in an adjudicative order. Each is a proper exercise of the Commission's discretion on how to implement policy. It is worth emphasizing that the choice of the vehicle for declarations of policy is for the Commission alone.⁹² Nevertheless, the provincial commissions when adopting policy statements have followed a procedure similar to that required for regulations by section 15.15 and it is expected that the Commission too will continue this practice.

Not even all rule-making requires the procedure specified in section 15.15. For example, regulations that deal only with matters internal to the Commission or that make no change in the substance of an existing regulation have no impact on private individuals and should not be subject to the procedural requirements; compliance with the section would merely cause unnecessary delays to no useful purpose. Subsection (5) therefore creates a number of exemptions from the rule-making procedure specified in subsections (1) and (2). It should be pointed out, however, that subsection (5) creates exemptions only from the predisclosure and hearing requirements. The Commission must always comply with subsection (4) and state reasons for the adoption of a rule.

The most obvious reason for not requiring the rule-making procedure is that the regulation in question has no impact on those subject to it, as is clear from the examples mentioned above.⁹³ The principle is expressed in the exemptions in paragraphs (5)(b) and

91 See sections 2.08, 15.14, Commentary.

92 Cf. *e.g.* *British Oxygen Co. Ltd. v. Minister of Technology*, [1971] A.C. 610 (H.L. 1970). But see *e.g.* FINAL REPORT OF THE SEC MAJOR ISSUES CONFERENCE 2 (1977) (rule-making and policy statements "preferred methodology by which to develop policy").

93 See *e.g.* paragraph (5)(e).

(c) and may be read into paragraph (5)(f). Paragraph (5)(b) in essence exempts internal rules of the Commission. But not all internal rules are without impact on persons subject to the Draft Act. Procedural rules, for example, often have a substantial effect on private individuals.⁹⁴ Where an internal rule is likely to have such an impact, the exemption is not available. This limitation derives from United States case law superimposing procedural requirements similar to those required by this section on rule-making proceedings otherwise exempt from the Administrative Procedure Act.⁹⁵

A similar principle is included in paragraph (5)(c) which exempts a regulation that grants an exemption from a requirement under the Draft Act or relieves a restriction. The provision derives from the Administrative Procedure Act, 5 U.S.C. s. 553(d)(1), and the Canada Business Corporations Act, s. 254(3)(a), but is more narrowly confined than the source provisions. An exemption, while relieving certain persons from an obligation under the Draft Act, may deprive others of protection granted by the Draft Act and may thus have a substantial impact on them; the exemption in paragraph (5)(c) is therefore available only when no such effects result from an exempting regulation.

The Administrative Procedure Act, 5 U.S.C. s. 553(d)(2), also exempts interpretative rules from the rule-making procedure. However, interpretative rules under the U.S. statute are little more than policy statements. If they have statutory authorization they are substantive regulations and are not entitled to the exemption.⁹⁶ As a result, no such exemption is included in the Draft Act.⁹⁷

The other exemptions may be treated summarily. Paragraph (5)(a) derives from the Administrative Procedure Act and is included to avoid the necessity of formal compliance where it would be superfluous. A similar reason underlies paragraph (5)(d) which derives from the Canada Business Corporations Act. The provision was included in the Canadian act to ensure that the rule-making procedure need not go on indefinitely because a regulation is changed as a result of representations made by interested persons, probably out of an abundance of caution and because the rule-making procedure is rather novel in Canada. In fact, it may be

94 See e.g. K. DAVIS at 205; P. ANISMAN, *supra* note 4, at 17.

95 See K. DAVIS at 205.

96 See e.g. K. DAVIS, CUMULATIVE SUPPLEMENT 49-52, 205-208 (1977).

97 Cf. Warren, *The Notice Requirement in Administrative Rulemaking: An Analysis of Legislative and Interpretive Rules*, 29 ADMIN. L. REV. 367 (1977) (Administrative Conference recommended that interpretive rules with substantial impact follow

unnecessary, for it is doubtful that a court would require an indefinite number of rule-making proceedings as is indicated by U.S. experience.⁹⁸

The final exemption, which permits the Commission to make regulations without following the procedure specified in subsections (1) and (2) where it has reason to conclude that to do so is impracticable or unnecessary, derives from the Administrative Procedure Act, 5 U.S.C. s. 553(d)(3), and is considered "essential" by Professor Davis, who has even suggested that it might be expanded.⁹⁹ It is intended to cover, among other things, emergency regulations and regulations that have little or no impact.¹⁰⁰ However, good cause to omit the rule-making procedure may exist in other circumstances as well.¹⁰¹ Although the exemption is broad, the requirement that the Commission state its reasons for concluding that the formal procedure is unnecessary or impracticable provides a safeguard against abuse that may be reinforced by judicial review.

Subsection (6) is included to make clear that any person may petition the Commission in relation to rule-making and to ensure that the Commission must consider such requests. The provision incorporates a practice that is not unknown in Canada in relation to policy statements.¹⁰²

Section 15.16

Section 15.16 deals with orders and is parallel to subsection 15.14(1), the general provision dealing with regulations. As the Commission is authorized in specific provisions throughout the Draft Act to make orders, section 15.16 gives it only general adjudicative powers concerning matters that are not limited to any one part of the Draft Act.

rulemaking procedure); see also Asimow, *Public Participation in the Adoption of Interpretive Rules and Policy Statements*, 75 MICH. L. REV. 520 (1977).

98 See K. DAVIS at 170-71; *Ethyl Corporation v. Environmental Protection Agency*, *supra* note 85, at 52.

99 See K. DAVIS at 203.

100 See e.g. SEC, Securities Exchange Act Release No. 13280, February 18, 1977, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,977 (rule less restrictive and technical).

101 See e.g. *British American Commodity Options v. Bagley*, 552 F.2d 482 (2d Cir. 1977) (previous disclosure of substance of rule and opportunity for comment and public participation); but see *Frankland Commodities Corporation v. CFTC*, Current, CCH COMMODITY FUTURES L. REP. ¶ 20,461 (N.D. Ga. 1977) ("not entirely persuaded by the decision of the Second Circuit").

102 See e.g. *Exposure Draft - A.S.C. Policy #3.03*, Alberta Securities Commission Summary, July 31, 1977 (solicitor of Alberta securities bar asked staff of Commission "if its policy...could be reviewed").

The section ensures that the Commission's power to make orders is virtually coextensive with its rule-making power. The Commission may, therefore, acquire experience with particular matters in specific cases before it proceeds to rule-making and thus is permitted, where appropriate, to "prick out its policy" by means of adjudication without being forced to formalize it legislatively.¹⁰³

The Commission is empowered to make a number of orders that are in effect declaratory of or grant a status. For example, an exemption from compliance with a Part of the Draft Act puts the person to whom it is granted in a special position as does a declaration that a particular trade is not a distribution subject to Part 5. Such orders affect persons other than the applicant by determining that they will not receive the protection of the Draft Act and are invariably based upon peculiar facts presented to the Commission by the applicant. Subsection (2) imposes an implied duty on the Commission to monitor such orders and to revoke or vary them if the facts on which they were based change. The duty is necessary because persons on whose behalf such orders are made are not likely to apply to the Commission requesting revocation or even modification.

Section 15.17

Because there is no legislation dealing generally with the minimum procedures to be observed by federal public authorities, section 15.17 establishes a procedure for the exercise by the Commission of its adjudicative powers. The section is the counterpart of section 15.15 which provides a procedure for the Commission's quasi-legislative, that is, rule-making, functions. ("Order" is used throughout the Draft Act where the Commission's decision is adjudicative.¹⁰⁴) The requirements of the section are relatively straightforward and add little to the elements necessary for natural justice.

Section 15.17 creates a code of procedure that attempts to maintain a reasonable balance between protection of individual liberties and the Commission's need to fulfill its functions in an efficient manner. As the source provisions indicate, a number of models for such a code are available in both Canada and the United States. The Canadian models, namely, the Ontario Securities Act and especially the Ontario Statutory Powers Procedure Act, ex-

103 Cf. Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in their Development*, 29 L. & CONTEMP. PROB. 691 (1964).

104 See section 2.27; but cf. sections 9.07, 9.08.

erted the primary influences on this section, although the U.S. sources provided the basis for subsections (9) and (10). Nevertheless, a number of variations should be mentioned.

Section 15.17 applies only when the Commission is to make a final order. In this regard it adopts one of the criteria usually applied at common law and adopted, either expressly or impliedly, in all of the statutory sources. Put simply, a final order is one that concludes a proceeding, subject to any rights of appeal or review that may exist. Thus the procedure necessary for interim orders or for temporary orders is left to the Commission's discretion and to rule-making.¹⁰⁵ It is, of course, expected that the Commission will act fairly when making such orders.

The Ontario Securities Act, s. 5.1, specifies the manner of sending notice ("by prepaid mail at the latest address of such person..."). The Draft Act deals with both this issue and the length of a notice in terms of "reasonableness". A reasonable opportunity for a hearing is sufficiently particular to ensure a notice period that will enable an affected person to prepare for the hearing and to preclude a delay so long that the person who is subject to Commission action may be unfairly prejudiced. In either case resort to the courts is available. Similarly, a reasonable notice is one that must be sent in a manner reasonably likely to reach the person in question. (The wording of the Ontario Statutory Powers Procedure Act, s. 6(1), is the same.)

The notice requirements in the Draft Act may be somewhat broader than those in the Ontario models. The Statutory Powers Procedure Act avoids the question by requiring that notice be sent only to the "parties"; the Securities Act, s. 5.1, requires that it be sent to persons "primarily affected" by the hearing. The Draft Act requires that persons "directly affected" receive notice. The phrase may be interpreted to require more generous notice than the Ontario act.¹⁰⁶ Thus under the Draft Act a substantial shareholder of an issuer is entitled to notice of a hearing to determine whether a cease trading order concerning the issuer's securities should be made.¹⁰⁷

A few more technical matters in subsection (1) should be raised. Although the Commission is required to give notice of a hearing to an interested self-regulatory organization, such organizations are not entitled to appear as of right. Rather, because

105 See subsections (9), (10); cf. ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 1513(b)(1)-(3), note (2).

106 Cf. Ontario Securities Act, 1978, s. 8(2).

107 Cf. *Re Henderson*, 14 O.R. (2d) 498, 500 (H.C. 1976) (substantial shareholder had to apply to Ontario Securities Commission for permission to appear; implicit basis that shareholder not "primarily affected").

they represent a viewpoint that in essence is independent of affected persons and thus perform a role analogous to that of an *amicus curiae*, they are treated as interveners and will be subject to rules made by the Commission pursuant to paragraph 10(c).

It is expected that most initial orders will be made by officers or individual members of the Commission who are the recipients of a delegation under section 15.09. As any power exercised by a delegate of the Commission is subject to the same requirements as if exercised by the Commission itself, the requirements of the section apply in such cases.

Subsection (2) gives the Commission the broad powers to compel attendance, testimony under oath or affirmation and the production of documents that it has in connection with investigations under part 14.¹⁰⁸ Some federal regulatory agencies exercise a contempt power that may be useful in maintaining order at hearings, and such a power has been recommended on an experimental basis in the United States.¹⁰⁹ However, the Commission is not given contempt powers in relation to its hearings and as with investigations must apply for a compliance order under section 14.06 when a person fails to obey an order issued by it.

Subsection (3) indicates a preference that hearings held by the Commission be open to the public. However, like the sources, the Draft Act permits the Commission to hold a hearing in private unless all of the persons affected request that it be open. (The subsection says "all persons directly affected and appearing" in order to preclude an *in camera* hearing because some persons who are given notice fail to appear.) The Commission's discretion to close a hearing is removed when all of the parties request that it be open, as it is their interests that an *in camera* hearing is intended to protect.¹¹⁰ A similar provision in the National Transportation Act requires that a hearing be open if *any* party so requests.¹¹¹ The Draft Act is preferable because there may be more than one party involved in a hearing held by the Commission.

Subsection (4) ensures that a person who is entitled to notice of a hearing may adequately present his case before the Commission. However, only the right to be represented by counsel is absolute under the section. Where no facts are in issue, oral evidence and a right of cross-examination are unnecessary and may serve only to delay a hearing. Even oral argument may not be

108 See section 14.01.

109 See e.g. National Energy Board Rules of Practice and Procedure, s. 21, added by SOR/77-225, March 10, 1977; COMMITTEE ON GOVERNMENTAL AFFAIRS, *supra* note 74, at 71-72; cf. Ontario Statutory Powers Procedure Act, s. 9(2).

110 See ALI FEDERAL SECURITIES CODE, s. 1817(e)(1).

111 R.S.C. 1970, c. N-17, s. 17.

required in all cases. The Commission is therefore given the power to make rules limiting a hearing to written submissions or oral argument when there is no genuine issue of material fact involved.¹¹² The Draft Act thus avoids imposing a rigid procedure appropriate for trials and gives the Commission the flexibility to adopt hearing procedures appropriate to the nature of the issues in question so that it may perform its statutory duties as efficiently as possible.¹¹³ Of course, any such rules adopted by the Commission are themselves subject to judicial review under section 15.20.

Similarly, the Commission may adopt rules governing the extent of participation in its proceedings by interested persons who are not directly affected. The Draft Act thus avoids forcing the Commission to choose between full participation or no participation at all as is required under the Ontario Statutory Powers Procedure Act.¹¹⁴

Subsection (7) requires the Commission to make provision for a transcript of testimony presented at a hearing in order to facilitate review of decisions by the Commission itself and by the courts. As the rules of court deal with the contents of an appeal case, the Draft Act does not attempt to specify the elements of a record of a Commission hearing.¹¹⁵ The Commission may make a similar rule under subsection (10) or subsection 15.18(5) for matters to be reviewed by it under section 15.18.

Subsection (8) too is directed toward judicial review in that it requires written findings and reasons for Commission orders. Although written reasons are not required at common law, they serve a number of useful functions.¹¹⁶ In addition to facilitating judicial (and other) review, they encourage fuller consideration of a decision and enable the persons affected to determine whether to proceed further.¹¹⁷ At least one Canadian tribunal has adopted an "almost invariable practice of giving written reasons" in order to achieve these ends.¹¹⁸ Indeed, the benefits that may be derived from the writing of reasons are substantial and the inconvenience to the Commission will likely be minimal. Only decisions involving questions of policy or principle, whether the adoption of new policy or a change in an existing policy, require substantial explanation.

112 See paragraph (10)(a).

113 Cf. COMMITTEE ON GOVERNMENTAL AFFAIRS, *supra* note 74, at 36-53.

114 See *Re Henderson*, *supra* note 107.

115 See e.g. Federal Court Rule 1305.

116 See e.g. *Dobson v. City of Edmonton*, 19 D.L.R. (2d) 69, 75 (Alta. S.C. 1959); *Proulx v. Public Service Staff Relations Board*, 20 N.R. 605, 615 (F.C.A. 1978); see also *id.* at 615-16 (*per Le Dain, J.*, dissenting).

117 See e.g. K. DAVIS, *DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY* 103-06 (1969).

118 See Getz, *The Corporate and Financial Services Commission - Reflections Upon a Statutory Tribunal*, 11 U.B.C. L. REV. 1, 5 (1976).

Routine decisions may be treated summarily and need contain only a statement of the salient facts and a reference to a regulation or an earlier Commission decision. In fact, as even a glance at any weekly summary of a provincial commission demonstrates, several of the commissions now follow a similar practice in relation to applications for exemptions.¹¹⁹ As a result, the requirement applies whether or not a decision is adverse to a party.¹²⁰ The last clause in paragraph (8)(c) is intended to protect parties to whom a decision is favourable.

Subsection (9) delineates the circumstances in which the Commission is not required to follow the procedure specified in the section. Paragraph (9)(a) exempts orders initiating an investigation under part 14. Although they are arguably not "final", such orders determine that there will be an investigation and insofar as the proceeding is concerned, they are conclusive. Paragraph (9)(a) is included to avoid any doubt about the question. Summary orders are not included in the subsection, however, as they are clearly interim orders and as all of the provisions authorizing them contain an express exemption from the requirements of section 15.17.

Paragraph (9)(b) exempts procedural orders that are likely to be made in the course of a proceeding. Although they may be final in effect, the parties to the proceeding will usually have an opportunity to make representations concerning them, and it would be merely cumbersome to force compliance with the procedural provisions of this section. The same is true of the denial of applications exempted by paragraph (9)(c); the applicant will always have notice and some opportunity to make his case before the denial of his application as is now the case with the most common type of application under the provincial securities acts, namely, an application for a declaration that a particular trade does not constitute a distribution.

Paragraph (9)(d) is included to avoid detailed procedural requirements that would merely hamper the Commission in the performance of its duties. Without it the Commission would have to comply with all of the procedural requirements of subsection (1) even where it intended to grant a registration or accept a prospectus. Thus paragraph (9)(d) permits it to summarily make orders that have no adverse impact on any person.

Subsection (9), however, provides only that subsection (1) is not applicable to the types of order included therein. The Commis-

119 See also K. DAVIS, *supra* note 117, at 104-05 (practice of Immigration Service).

120 Cf. e.g. Alberta Administrative Procedures Act, R.S.A. 1970, c. 2, s. 8; and see *Re Northwestern Utilities Limited*, 2 Alta. Rep. 317, 333-35 (App. Div. 1976); *Dome Petroleum Ltd. v. Public Utilities Board (Alberta)*, 13 N.R. 299, 2 Alta. Rep. 451 (S.C.C. 1977).

sion must still comply with subsection (8) in respect of such orders by writing and publishing reasons for them. And any orders made under the subsection are subject to judicial review.¹²¹

Subsection (10) authorizes the Commission to make rules prescribing procedures for hearings. Pre-hearing procedures are expressly included so that the Commission may adopt rules governing or requiring discovery.¹²² Paragraphs (a) to (c) specify several matters included within the general rule-making power granted by the subsection to make clear that they are within its scope and to encourage the Commission to turn its mind to them. The Commission may also adopt rules regulating other matters relating to the conduct of a hearing such as *ex parte* communications between a person involved in the making of an order and a party.¹²³

Section 15.18

Under the scheme envisaged in part 15 the Commission itself will rarely make initial decisions. Rather it will delegate most of its adjudicative powers to individual commissioners or employees who will issue orders that the Commission is authorized to make under the Draft Act.¹²⁴ As such orders are made by delegates of the Commission, any order that disposes of a proceeding is a final order of the Commission itself and is determinative of the issues in question unless it is altered on appeal.

Section 15.18 provides for appeals to and review by the Commission of such orders and also of orders made by a self-regulatory organization. The terms used in the section indicate the nature of the review contemplated. It is not intended that *de novo* hearings be available before the Commission every time one of its delegates or a self-regulatory organization makes an order, for the initial hearing would then be little more than a superfluous formality. Rather the section contemplates appellate review by the Commission of such orders on the initiation of persons directly affected (subsection (1)) or of the Commission itself (subsection (2)) so that the Commission may review matters of policy in the administration of the Draft Act, ensure consistency of its application by its

121 See section 15.19.

122 Cf. ATTORNEY GENERAL OF ONTARIO, NOTICE TO THE PROFESSION: THE ATTORNEY GENERAL'S GUIDELINES ON DISCLOSURE IN CRIMINAL CASES (undated 1977); Frey v. Commodity Exchange Authority, 547 F.2d 46 (7th Cir. 1976).

123 Cf. e.g. SEC, Securities Act Release No. 5815, [1976-1977 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,989 (March 10, 1977) (adopting "code of behavior governing *ex parte* communications between persons outside the Commission and decisional employees"); CFTC Rules of Practice, Rule 10.10, CCH COMMODITY FUTURES L. REP. ¶ 2260 (effective March 12, 1977).

124 See section 15.09.

delegates and by self-regulatory organizations and provide a check on potential inequities to appellants. The Commission may fashion its own procedure for appeals and review (subsection (5)), and its power to modify or reverse orders is plenary (subsection (3)). As the Commission may consider a matter on the merits and substitute its decision for the one under review (or remand it, if appropriate), the rules promulgated by it under subsection (5) are likely to permit oral argument in most cases. However, they may specify certain types of cases where only a summary form of appeal is permitted, for example, by means of written briefs of a specified maximum length, in order to deal expeditiously with cases that involve no serious policy or factual issues. And only in exceptional cases would the Commission be likely to permit the introduction of new evidence.¹²⁵

Although only final orders of delegates of the Commission may be appealed as of right under subsection (1), all orders whether final or not are subject to review by the Commission under subsection (2). It is expected that the Commission will develop its own procedures for internal review of powers delegated by it under subsection 15.09(1) and, presumably, formalize them by rule. (The Draft Act itself requires that self-regulatory organizations give notice of orders made under section 9.09.¹²⁶) And the Commission may, under subsection (5), prescribe rules for appeals to it from orders of its delegates that are not final. Thus it is expected that the Commission will itself establish standards and procedures for review of all orders of its delegates and for appeals from their interim orders, made, for example, during the course of a hearing under section 15.17. Similarly, although subsection (1) gives a right of appeal only to persons directly affected by a final order, any aggrieved person may apply to the Commission for review under subsection (2) and such applications, presumably, will also be dealt with in Commission rules.

If the Commission itself decides to review an order, subsection (2) requires that it provide persons who are directly affected by the order, including a self-regulatory organization that may have made it, with an opportunity for and notice of a hearing. As in section 15.17 both must be reasonable, but the contents of the notice are not specified here. In accordance with the approach discussed above, both are left to Commission rule-making, as are the time periods for appeal and review, and both are reviewable by

125 *Cf. e.g.* In the Matter of James A. Carr, CCH COMMODITY FUTURES L. REP. ¶ 20,454 (CFTC 1977) (expedited review procedure).

126 *See* subsection 9.10(1).

a court either on review of the rule itself or on an appeal from an order.

By including appeals from and review of orders of a self-regulatory organization, section 15.18 treats them in the same manner as orders of Commission delegates and subjects them to the same type of review essentially for the same reasons, as well as to aid the Commission in the performance of its supervisory duties. Thus the section complements subsections 9.10(2) to (5). Since the earlier subsections include an order denying a person access to services of a self-regulatory organization, a decision of a registered securities exchange to deny listing or to delist an issuer is also subject to Commission review. Moreover, section 9.10 prescribes detailed standards for Commission review of self-regulatory orders in contrast to the unguided discretion embodied in subsection (3). Although the generality of subsection (3) is probably satisfactory for review of orders made by the Commission's delegates, the further guidance is required for its review of self-regulatory orders.¹²⁷

Finally, a person who appeals an order may apply for a stay of its effect.¹²⁸ But a person who does not appeal the order of a delegate or of a self-regulatory organization to the Commission has no further rights of appeal, for subsection 15.19(2) makes clear that exhaustion of the remedies available within the administrative process is a prerequisite to judicial review.

Section 15.19

Canadian securities legislation has generally permitted judicial review of commission decisions.¹²⁹ The Draft Act continues this approach whether the Commission acts by regulation or order; section 15.20 permits review of Commission rule-making and section 15.19 deals with adjudicative decisions.

Section 15.19 thus entitles a person directly affected by a final order of the Commission to appeal it to a court. An appeal lies whether the Commission's order is the initial one made pursuant to section 15.17 or is made on appeal or review under section 15.18.

127 Cf. CFTC, *Notice: Commission Review of Exchange Disciplinary or other Adverse Action: Proposed Rulemaking*, CCH COMMODITY FUTURES L. REP. ¶ 20,428 at 21,747 (June 14, 1977) (proposed rule 9.37). And see generally SEC, Securities Exchange Act Release No. 13726, [1977-1978 Transfer Binder] CCH FED. SEC. L. REP. ¶ 81,225 (July 8, 1977) (notices of and appeals from disciplinary decisions by self-regulatory organizations).

128 See subsection (4); and see, *In re Fisher Securities Corporation Ltd.*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, June 3, 1977, 9 at 12-14 (Corporate and Financial Services Commission) (discussing need for stays).

129 See e.g. Ontario Securities Act, s. 29.

However, no appeal lies from the decision of a delegate of the Commission even though such a decision may be "a final order of the Commission", unless the order is first appealed to the Commission itself under subsection 15.18(1), for subsection (2) requires the exhaustion of all administrative remedies, subject to a "reasonableness" qualification, before an appeal to the court is available.¹³⁰ This requirement is included so that the Commission, rather than the court, has primary responsibility for ensuring that its policies are consistently applied. (It is expected that the Commission will adopt rules to expedite appeals to it that do not involve substantial questions of fact, law or policy.¹³¹)

The Draft Act departs from the pattern in modern federal legislation by permitting appeals to the appellate division of any superior court in Canada.¹³² Since 1970 either the trial or appellate division of the Federal Court of Canada has had exclusive jurisdiction to review decisions of or hear appeals from orders of all federal agencies.¹³³ Such exclusive jurisdiction, however, would be likely to limit unduly the availability of review of Commission action. Under the Draft Act, as is already apparent, the Commission has wide jurisdiction to supervise trading in securities and the activities of market actors throughout Canada in the context of a securities market in which decisions frequently must be made quickly.¹³⁴ Given the scope of its jurisdiction and the nature of the securities market itself, it will probably not be uncommon for the Commission to make a number of orders within a relatively short period that directly affect people throughout the country in a substantial way. For example, a Commission order under section 3.04 denying an exemption to a selling securityholder or to an issuer may result in substantial costs to either because of the delay involved in complying with the Draft Act. Similarly, disciplinary action against a registrant under section 8.02 may deprive him of his livelihood, a serious consequence even if only for a short period. And the effects of a cease trading or freeze order do not require further explication.¹³⁵ In short, a Commission actively pursuing its duties under the Draft Act will be constantly engaged in a variety of supervisory activities the results of which may have a substantial economic impact on people in all parts of Canada.

One of the major purposes of part 15 is to ensure that such persons are treated fairly when decisions are made. An opportuni-

130 See generally section 15.18 and Commentary.

131 See subsections 15.17(10), 15.18(5) and Commentary.

132 See subsection 16.05(3).

133 See Federal Court Act, ss. 18, 29 and 30; and see *Pringle v. Fraser*, [1972] S.C.R. 821.

134 See e.g. section 14.04 and Commentary.

135 See sections 14.04, 14.05 and Commentary.

ty for expeditious judicial review of Commission decisions that affect them directly is therefore an essential element of the administrative pattern. Indeed, given the potential impact of many Commission orders, the timeliness of the review may be as important as the review itself. Although the Federal Court has apparently made great efforts to convene hearings quickly wherever they are required in Canada, the activity of the securities market and the potential diversity and geographical breadth of Commission orders would likely make it exceedingly difficult for the Court to continue its practice even without its present responsibilities for review of other federal agencies. The result would probably be either an impossible burden for the Court or substantial delays in the ability of affected persons to obtain review, which would often negate the effectiveness of judicial review and thus undercut one of the major objectives of part 15. The advisers therefore recommended that judicial review of Commission orders and regulations be available in both the Federal Court and in the provincial superior courts. The Draft Act embodies that recommendation. As a result, a person desiring to appeal an order or a regulation of the Commission may do so in the appellate division of the superior court in his province or in the Federal Court of Appeal. While the resurrection of concurrent jurisdiction to review the activities of a federal agency is somewhat novel, it is expected that it will result in a fairer and more efficient implementation of the Draft Act.

The Draft Act therefore follows the experience in Canada with appeals from securities commissions rather than the more recent recommendations relating to the division of review jurisdiction within the Federal Court.¹³⁶ In any event, review by the Trial Division subject to a further appeal to the Court of Appeal, especially in the context of internal review by the Commission of decisions of its delegates required by the Draft Act, would merely interpose an unnecessary level of review and increase expenses to litigants.

Unlike the *ALI Code*, the Draft Act does not specify the time during which an appeal must be taken. In fact, the Draft Act avoids the imposition of a single procedure so that the rules relating to appellate review in the court in which an appeal is taken will prevail. (The *ALI Code*, s. 1818(a), permits sixty days while the

136 See e.g. LAW REFORM COMMISSION OF CANADA, FEDERAL COURT: JUDICIAL REVIEW 15-23 (Working Paper 18, 1977) (recommending that all judicial review be initiated in the Trial Division and that "special appeals" should be minimized); cf. Jackett, *The Federal Court of Appeal*, 11 OSGOODE HALL L.J. 253, 260-61 (1973) (appeals should exist only where tribunal "functions essentially as a court of law functions" and "merely finds facts and applies rules of law to them" and not where tribunal "vested with power to exercise a discretion...for which it has special 'expertise'").

general review section of the Federal Court Act permits only ten days subject to the Federal Court's discretion to extend.¹³⁷

The procedures that are specified in section 15.19 are generally like those in the provincial legislation.¹³⁸ Thus subsection (3) precludes an automatic stay of an order that is appealed and permits either the Commission or a court to grant a stay until the appeal is decided. However, as the rules of court relating to appeals from tribunals usually specify the material to be submitted on an appeal and also require notification of the Commission, no attempt to specify such requirements has been made in the Draft Act. Nevertheless, the Commission may supplement those rules by prescribing the nature of its record under subsection 15.17(10).¹³⁹

Although only final orders may be appealed under section 15.19, interim orders made by the Commission during an adjudicative proceeding and certain summary orders that are not within the section may still be the subject of an application to a court.¹⁴⁰ Under the Federal Court Act such applications would be made to the Trial Division of the Federal Court.¹⁴¹ However, subsection 16.05(4) of the Draft Act treats them in the same manner as appeals and extends the jurisdiction to entertain applications to review interim orders of the Commission to the provincial superior courts. Although such applications are likely to be less frequent than appeals, the same considerations apply to them. In any event, questions concerning interim orders can be raised on an appeal after a final order is made. The Draft Act therefore encourages the courts to take into account such issues as prematurity and the ripeness of a matter for review when determining whether an appeal lies.¹⁴²

Subsection (4) deserves some attention. It authorizes the Commission to appear and be heard by counsel or otherwise on any appeal under section 15.19 or on any other application to a court relating to the exercise by it of its powers under the Draft Act. The provision is drafted broadly to ensure that the Commission may be heard on the merits and includes both appeals and applications concerning interim orders. In light of a number of judicial statements its breadth may appear somewhat novel in Canada. Ca-

137 See Federal Court Act, s. 28(2).

138 See e.g. Ontario Securities Act, s. 29.

139 Cf. e.g. Federal Court Rules 1302(4), 1305, 1306; cf. Ontario Securities Act, 1978, ss. 9(2), (3).

140 See e.g. *Re Millward*, 49 D.L.R. (3d) 295, 297 (F.C.T.D. 1974) (application for declaration and order to quash ruling that inquiry be held *in camera*).

141 See Federal Court Act, s. 18.

142 See subsection (2); cf. *Re Attorney-General of Canada and Cylien*, 43 D.L.R. (3d) 590 (F.C.A. 1973).

nadian courts have tended to allow a tribunal to appear and be heard on questions relating to its jurisdiction, but not on the merits of the decision itself and not even on a question of law not going to its jurisdiction.¹⁴³

Subsection (4) is an analogue of the broad powers of intervention given the Commission in section 14.08. Under the Draft Act initial administrative decisions are likely to be made by a delegate of the Commission and reviewed by the Commission itself before an appeal is taken to the court. Such cases will be prepared and presented at all administrative levels by the Commission's legal staff, and this division of functions is reinforced by the requirement that a decision-making delegate not be involved in enforcement activities.¹⁴⁴ In other words, although the Commission will provide policy guidelines for enforcement, it will participate in enforcement proceedings (and other adjudicative proceedings) only in a quasi-judicial capacity. In the light of this scheme it is necessary that the Commission's legal staff or counsel retained by it be entitled to appear on appeals and other applications. It is for this reason that the Canadian source provisions authorize "the Minister" to be heard by counsel (usually selected by and often an employee of the Commission) on an appeal and that the Draft Act includes subsection (4).¹⁴⁵

Subsections (5) and (6) specify the scope of review by a court on appeal. The former provision follows the Canadian sources which give the courts unguided discretion to make any order that the Commission itself might have made. In practice, however, the courts have tended to affirm a decision that is reasonably supported by the evidence presented before the Commission (a "substantial evidence" standard of review) and to give special weight to conclusions of the commissions in matters within their area of expertise.¹⁴⁶ And even though the Supreme Court of Canada has mandated careful consideration of all of the evidence on such appeals, the courts have continued to apply a substantial evidence

143 See e.g. *Central Broadcasting Co. Ltd. v. Canada Labour Relations Board*, 9 N.R. 345, 352 (S.C.C. 1976); *Re Zolondek*, 15 N.B.R. (2d) 665, 678 (N.B. App. Div. 1976); but see, *Re Canadian Radio-television Commission*, 15 N.R. 111, 113 (S.C.C. 1977) (Commission, as respondent, represented by counsel); and see *Re City of Dartmouth*, 17 N.S.R. (2d) 425, 440 (N.S. App. Div. 1976) (although Board of Commissioners of Public Utilities entitled to appear to defend correctness of own decision, discouraged by court).

144 See section 15.09 and Commentary.

145 See e.g. *Ontario Securities Act*, s. 29(4); *Ontario Securities Act*, 1978, s. 9(4); cf. *In re Frank Slichter*, B.C. Corporate, Financial and Regulatory Services Weekly Summary, June 30, 1977, 4 at 5 (B.C.C.A. 1977).

146 See e.g. *Re Larrimore Securities Ltd.*, 4 D.L.R. (2d) 727 (Ont. C.A. 1956); *Re Pacific Coast Coin Exchange*, 8 O.R. (2d) 257 (Ont. C.A. 1975), *affirmed*, 18 N.R. 52 (S.C.C. 1977); cf. *Howard* at nn. 120-21.

standard of review.¹⁴⁷ Consequently no attempt has been made to impose general standards for review in section 15.19.¹⁴⁸

Subsection (5) does, however, differ from the provincial models by expressly authorizing a court to remand a case to the Commission for further proceedings on conditions that the court thinks appropriate. A court may thus require the Commission to permit new evidence to be presented, to conduct further hearings relating to facts that it failed to consider, or only to give further reasons for its order. The power to remand to the Commission is intended to be exclusive; in other words, it is intended that a court have no power to hear new evidence or conduct a *de novo* review itself but must remand such matters to the Commission for its consideration.

Subsection (6) also varies from the provincial provisions by specifying the standard for review of cease trading and freeze orders. Such orders are intended to be used in situations requiring fast action, and the Commission is in the best position to determine when they are necessary and the type of conditions that are appropriate to them (albeit, perhaps, more so with regard to the former than the latter). Thus a court may not modify such orders on review but may only confirm or revoke them. And the standard for review is not substantial evidence but arbitrariness or abuse of discretion. In other words, a court may only reverse an order of the specified types that patently should not have been made or that has been unreasonably extended. Professor Davis suggests the same standard should apply to review of penalties imposed by a commission.¹⁴⁹

A few orders under the Draft Act are not appropriate for appeal under section 15.19. Most obvious are orders issued under sections 9.07 and 9.08 that require amendment of self-regulatory by-laws or approve rates fixed by a self-regulatory organization. As the procedure specified for such orders is essentially the rule-making procedure of section 15.15, they are more appropriately reviewable under section 15.20 which deals with judicial review of rule-making.¹⁵⁰ Summary orders authorized by the Draft Act are also not appropriate for appeal to a court. (In any event their appeal would likely be precluded by subsection (2).) And orders

147 See e.g. *In re Frank Slichter*, *supra* note 145; cf. *Hretchka v. A.G.B.C.*, [1972] S.C.R. 119, 129-30 (1971); and cf. *Whiteside & Co. v. Securities and Exchange Commission*, 557 F.2d 1118, 1121 (5th Cir. 1977).

148 But see Federal Court Act, s. 28(1); and see LAW REFORM COMMISSION OF CANADA, *supra* note 136, at 27-31.

149 See K. DAVIS at 682; and see e.g. *Arthur Lipper Corporation v. Securities and Exchange Commission*, 547 F.2d 171, 183-85 (2d Cir. 1976).

150 See subsection 15.20(6).

that refuse an application for an exemption or declaration are also not reviewable.¹⁵¹

Finally, subsection (8), like the provincial sources, authorizes the Commission to reconsider any order, whether or not appealed to a court. A change of circumstances is expressly included here, as in the provincial legislation, to make clear that the Commission is entitled to reconsider an order not only on the basis of new evidence but also on the basis of the policy underlying it.¹⁵² Any such proceedings would, of course, be subject to the procedural requirements of section 15.17.

Section 15.20

The Draft Act gives the Commission broad rule-making powers but makes their exercise subject to judicial review. Section 15.20, which establishes the procedures and standards relating to appeals concerning regulations, is framed so that review may be obtained with relative ease.

Standing to appeal a regulation is broader than that specified for an appeal from an order of the Commission under section 15.19. Whereas only a person directly affected by an order may appeal it, any person affected by a regulation may do so. The greater breadth of section 15.20 is necessitated by the legislative nature of regulations in contrast to the adjudicative, or more specific, character of orders under the Draft Act.¹⁵³ And any regulation made by the Commission may be the subject of an appeal under this section whether or not it is exempt from the procedures specified in subsection 15.15(1).

Subsection (1) does not deal with the time for appeal of a regulation; as in section 15.19, this question is left either to Commission rule or for the court to deal with as a question of ripeness or unnecessary delay.¹⁵⁴ It should be pointed out, however, that the period specified in the Federal Court Act, s. 28(2), for review of agency action is likely far too short for review of rule-making because the existence of a new regulation may not come to the attention of persons affected by it until some time after it is promulgated. This fact is recognized by the *ALI Code* which expressly authorizes a court to extend the sixty-day period otherwise allowed for applications for judicial review "if the nature of the rule change and the manner of its effectuation or enforcement are such that a petition for review could not reasonably have been

151 See paragraph 15.17(9)(c) and Commentary.

152 See e.g. Ontario Securities Act, 1978, s. 9(6).

153 Cf. LAW REFORM COMMISSION OF CANADA, *supra* note 136, at 39-40.

154 Cf. Federal Court Rule 1308.

filed” within that period.¹⁵⁵ (Although the *ALI Code* refers to “rule changes”, the Draft Act, in accordance with the terminology adopted in section 15.15, refers only to a “regulation” on the basis that the making of a regulation includes amendment or repeal.¹⁵⁶)

As under section 15.19, concurrent jurisdiction to review regulations is granted to the Federal Court of Appeal and to the appellate division of a superior court in the jurisdiction in which an applicant resides or carries on business.¹⁵⁷ And review of rule-making is characterized as an appeal in order to approximate it to the preceding provision. In fact the general structure of this section follows that of section 15.19. Subsection (2) authorizes stays but has been modified to avoid any ambiguity about the Commission’s authority to determine the date upon which a regulation becomes effective.¹⁵⁸ And there is no need to repeat the principle of exhaustion in subsection 15.19(2), as the Commission may not delegate its rule-making powers.¹⁵⁹

As with appeals of orders, an appellant is usually required to notify the Commission of an appeal by the rules of court and the requirement is not repeated in the Draft Act.¹⁶⁰ However, the rules of court have been drafted with appeals from adjudicative decisions in mind.¹⁶¹ For example, Federal Court Rule 1302(4) requires that a notice of appeal be served “on all interested persons”, a requirement that may be extremely difficult, if not impossible, to meet where a regulation is appealed. And, equally important, the possibility of an appeal of a regulation in each provincial appellate court may create difficulties arising from multiple actions concerning the same regulation.¹⁶² Some reconsideration of the rules of court concerning such matters may therefore be necessary when the Draft Act is translated into legislation, and it is expected that the Commission will undertake discussion of these matters with the Canadian Judicial Council.¹⁶³

The contents of an appeal case specified in the rules of court also appear to have been framed on the assumption of an adjudica-

155 *ALI FEDERAL SECURITIES CODE*, s. 1818(b)(1)(C).

156 *See* section 15.15, Commentary.

157 *See* subsection 16.05(3); and *see* section 15.19, Commentary.

158 *Cf.* subsection 15.19(3) and Commentary.

159 *See* subsection 15.09(1).

160 *See e.g.* Federal Court Rule 1302(4).

161 *See e.g.* Federal Court Rules, Division C.

162 *Cf.* Arthurs, *Administrative Law – Jurisdiction of Provincial Supreme Court to Review Acts of Federal Administrative Agency – The Perambulating Plaintiff in Search of a Federal Forum*, 40 *CAN. B. REV.* 505 (1962); *ALI FEDERAL SECURITIES CODE*, s. 1818(c).

163 *Cf.* section 13.04, Commentary.

tive proceeding.¹⁶⁴ Although the requirements of the rules may, as with Rule 1305, be sufficiently general to be susceptible of application to an appeal from a rule-making proceeding, subsection (3) prescribes the materials that must be sent by the Commission to the reviewing court upon receipt of a notice of appeal in order to provide certainty as to the nature of the record on appeal. Thus a rule-making record consists of the materials required to be published under section 15.15 and any documents referred to in them.¹⁶⁵ (The record for a rule exempt from subsection 15.15(1) would include the materials required under the section and in particular under subsection 15.15(4).)

Paragraph (3)(c) requires as well a transcript of any testimony and of any oral presentation permitted by the Commission and thus requires, in effect, that the Commission make a transcript of any material orally presented, including oral argument. The requirement is broader than that in subsection 15.17(7), which applies only to testimony, in order to ensure that material obtained by the Commission in informal hearings such as roundtable discussions and on which it relies in its rule-making is part of the record.

The specification of the record is based on Recommendation 74-4 of the Administrative Conference of the United States¹⁶⁶ which was adopted with one minor modification, the addition of the equivalent of paragraph (3)(g), in the *ALI Code*.¹⁶⁷ Although the record may in some cases be large, Canadian courts have demonstrated their ability to deal with similar difficulties in reviewing rate decisions made by public utility commissions.¹⁶⁸ The requirement will, however, place a greater burden on counsel and the Commission to organize the record and their arguments in order to highlight the parts of the record relevant to the issues on appeal.¹⁶⁹

The Commission is expressly authorized to appear and be heard on the merits of a rule-making appeal, despite the overlap with subsection 15.19(4) which applies to all applications to a court "relating to the exercise by the Commission of its powers" as well as to appeals from Commission orders. Subsection (4) is included in section 15.20 out of an abundance of caution to ensure that the Commission's right to appear on an appeal of one of its regulations

164 See e.g. Federal Court Rule 1305.

165 See paragraphs (3)(a), (b), (f).

166 Quoted in K. DAVIS at 669-70.

167 See ALI FEDERAL SECURITIES CODE, s. 1818(b)(1)(A).

168 See e.g. *Re Northwestern Utilities Limited*, 2 A.R. 317, 329-30, 335 (App. Div. 1976).

169 Cf. *Ethyl Corporation v. Environmental Protection Agency*, 541 F.2d 1, 67 (D.C. Cir. 1976) (*per* Bazelon, C.J., concurring).

cannot be abrogated by interpreting the general clause of subsection 15.19(4) as applicable only to applications relating to interim orders and not to appeals expressly authorized by other sections of the Draft Act.

In contrast to subsection (1), subsection (5), which prescribes the scope of judicial review of Commission rule-making, is narrower than its equivalent relating to appeals of orders.¹⁷⁰ Whereas under the preceding provision an appellate court may make any order that the Commission might have made, under this section it may only confirm or revoke a regulation or remand the matter to the Commission for further proceedings. The limitation on the courts' discretion results from the fact that Commission rule-making is delegated legislation, a function inappropriate for the substitution of judgment by a court. On remand, however, a court might require a further opportunity for interested persons to make representations, an evidentiary hearing on specific facts or merely amplification of the Commission's reasons for adopting a regulation. And it may avoid the harmful consequences that would ordinarily flow from a regulation being ineffective as a result of a remand by imposing conditions under subsection (5) or by using its authority under subsection (2) to order a "partial stay" of the regulation, that is, by staying the effectiveness only of the part of the regulation that is in question.¹⁷¹ Canadian courts have not in the past hesitated to remand a case to an agency for reconsideration.¹⁷²

Subsection (5) also establishes the standards for review of regulations; the court may revoke a regulation only if one of the conditions in paragraphs (5)(a) to (e) is found to exist. Paragraphs (a) to (d) are based upon the Administrative Procedure Act of the United States and paragraph (e) results from the inclusion of subsection 15.15(3). Most of the standards are straightforward and their application will provide no difficulty for Canadian courts, which are accustomed to interpreting statutes and have always been prepared to declare an *ultra vires* regulation invalid or to strike down a regulation made in violation of prescribed procedures and which are familiar with the application of the Canadian Bill of Rights.¹⁷³

The only standards that might be considered novel are those

170 Compare subsection 15.19(5).

171 See e.g. *Union Oil Company of California v. Federal Power Commission*, 542 F.2d 1036, 1038 (9th Cir. 1976).

172 See e.g. *Re Northwestern Utilities Limited*, *supra* note 168; *Re Canadian Radio-television Commission*, 13 N.R. 292, 29 C.P.R. (2d) 268 (F.C.A. 1976), *appeal quashed as moot*, 15 N.R. 111 (S.C.C. 1977).

173 See paragraphs (5)(b), (c), (d); see also e.g. *R. v. CKOY Ltd.*, 13 O.R. (2d) 156 (C.A. 1976).

specified in paragraphs (5)(a) and (e) and even they are more so in appearance than in reality. Canadian courts have long applied similar standards on appeals from adjudicative decisions of statutory tribunals¹⁷⁴ and are not unaccustomed to applying the basic standard for review, that of arbitrariness or capriciousness, to regulations, usually in the form of by-laws.¹⁷⁵

Although paragraph (5)(e) authorizes revocation of a regulation not supported by the evidence, the standard is applicable only when the Commission holds an evidentiary hearing to determine specific facts in connection with its rule-making and then only in relation to that part of the proceeding. This standard accords with the recommendations of the leading scholar in the field of administrative law.¹⁷⁶ As a result, paragraphs (5)(a) and (e) are mutually exclusive so that a regulation will not be arbitrary or constitute an abuse of discretion even if there is not substantial evidence to support facts not subject to paragraph (5)(e) that are relied on in the Commission's statement of reasons for adopting it. In other words a court is entitled to weigh the evidence presented only in connection with a specific fact for which an evidentiary hearing is convened under subsection 15.15(3). (Presumably, however, there must be *some* evidence to support the Commission's reasons even under paragraph (5)(a).¹⁷⁷) Thus the Draft Act differs from the present, albeit inconsistent, tendency of U.S. reviewing courts to equate a lack of substantial evidence in support of a regulation with an abuse of discretion.¹⁷⁸ It may not differ, however, from the parallel tendency to scrutinize a rule-making record carefully on review to ensure that an agency has considered the representations made to it in connection with the regulation.¹⁷⁹

The Draft Act does not attempt to allocate the burden of proof on review of Commission rule-making. This question is still not clearly settled in the United States and is inextricably related to the adequacy of the factual basis and reasons included in the statement of basis and purpose required by subsection 15.15(4). As

174 See e.g. section 15.19, Commentary.

175 See e.g. B. SCHWARTZ & H. WADE, *LEGAL CONTROL OF GOVERNMENT: ADMINISTRATIVE LAW IN BRITAIN AND THE UNITED STATES* 96 (1972); and see generally C. ALLEN, *LAW IN THE MAKING* 536-65, 568-70 (7th ed. 1964).

176 See K. DAVIS at 664-65 ("substantial evidence" standard).

177 Cf. *E.I. du Pont de Nemours & Company v. Train*, 541 F.2d 1018, 1035-39 (4th Cir. 1976), *affirmed*, 97 S. Ct. 965 (1977).

178 See e.g. *Union Oil Company of California v. Federal Power Commission*, *supra* note 171, at 1040-44; but see *Ethyl Corporation v. Environmental Protection Agency*, *supra* note 169, at 37 (only "rational basis in the evidence" required); and see generally K. DAVIS, *CUMULATIVE SUPPLEMENT* 208-13 (1977).

179 See e.g. *id.* at 210; *Natural Resources Defense Council, Inc. v. United States Nuclear Regulatory Commission*, 547 F.2d 633, 644-46 (D.C. Cir. 1976).

a result it is left to the courts to determine in specific cases but it is expected that they will look to U.S. experience on this issue.¹⁸⁰

Finally, subsection (6) makes clear that a Commission order requiring a self-regulatory by-law or approving the rate structure of a self-regulatory organization is subject to judicial review under this section.¹⁸¹

Section 15.21

Section 15.21 ensures that the exclusive means for judicial review of Commission action that is appealable under section 15.19 or 15.20 is by means of an appeal under those sections. The section thus makes clear that none of the common law remedies is available in such cases.¹⁸² Nevertheless, Commission action not subject to those sections may be the subject of an application to a superior court, including the Trial Division of the Federal Court.¹⁸³

Section 15.21 goes further than the analogous provision in the Federal Court Act (s. 29) and, to avoid an adjournment so that a review proceeding may be initiated, permits an order or regulation of the Commission to be questioned in an action or proceeding in which its validity is raised by way of defence, even though it is reviewable under section 15.19 or 15.20.

Section 15.22

Section 15.22 derives from the provincial securities acts and follows the wording of the Ontario Securities Act, 1978. It provides immunity to commissioners and employees of the Commission, but not to the Commission itself as does the source provision, from liability for damages caused by them in the performance in good faith of their duties under the Draft Act.

Section 15.23

Instances of the misuse of confidential information by employees of securities commissions are not unheard of in Canada or the United States.¹⁸⁴ And a recent report in the United Kingdom has made recommendations on the misuse of confidential informa-

180 See e.g. *K. DAVIS* at 675-77; cf. *Pacific Coast Coin Exchange of Canada v. Ontario Securities Commission*, 18 N.R. 52, 59 (S.C.C. 1977).

181 See subsection 15.19(8) and Commentary.

182 Cf. *Re Canadian Pacific Transport Co. Ltd.*, [1977] 1 W.W.R. 692, 701 (B.C.S.C. 1976) (*certiorari* lies even where statutory right of appeal).

183 See section 15.19, Commentary; and see subsection 16.05(4).

184 See e.g. *WINDFALL REPORT*, ch. 10; *ST. STEPHENS NICKEL MINING REPORT*; *U.S. v. Peltz*, 433 F.2d 48 (2d Cir. 1970).

tion by public servants and their tippees that are strikingly similar to those embodied in the Draft Act.¹⁸⁵

Section 15.23 prohibits an employee, a person retained by the Commission or a commissioner from using confidential information obtained as a result of his position with the Commission for his own benefit or advantage and from disclosing such information to any person other than an official or employee of a Canadian or foreign government in connection with the enforcement of the Draft Act or securities legislation of another jurisdiction. A person who receives such information is subject to the same duties as an employee of the Commission. Subsection (3) is framed to make clear that a tippee is subject to subsections (1) and (2) and therefore to the standards in them.

Further exemptions from the restrictions upon disclosure in this section may be required in connection with the administration of the Draft Act. For example, it may be necessary to disclose certain types of information to an official of a self-regulatory organization of which a registrant is a member. The Commission may deal with such cases through its general exempting power under section 3.03 and by making rules pursuant to paragraph 15.13(1)(e). In fact, it is likely that it will do so immediately, at least in respect of registered self-regulatory organizations.

The approach in this section follows that adopted in part 12. The prohibited conduct is described in objective terms and the mental element necessary for a criminal conviction or for civil liability is dealt with in parts 14 and 13, respectively. Thus a person may not be convicted of violating section 15.23 unless it is proved that he did so knowingly or recklessly.¹⁸⁶ And as neither the section nor a provision of part 13 expressly provides for civil liability for a violation, it is open to a court to imply it under section 13.16.

Sections 15.24 and 15.25

These sections are included to round out the administrative scheme of the Draft Act. Section 15.24 is necessary to authorize the refund of fees the retention of which would be unjust. And section 15.25, which derives from the Broadcasting Act (there is no equivalent provision in the new Telecommunications Act) and the National Energy Board Act, gives the Commission a separate appropriation from Parliament and, although appropriations must be

185 See ROYAL COMMISSION ON STANDARDS OF CONDUCT IN PUBLIC LIFE 1974-1976, REPORT, Cmnd. 6524, ¶¶ 182-93 (1976).

186 See subsection 14.10(2).

approved by the Minister,¹⁸⁷ thus emphasizes its independence from any department.

187 See Financial Administration Act, R.S.C. 1970, c. F-10, s. 26.

Part 16

General

Regulatory statutes invariably contain a number of provisions that are essential to the regulatory scheme but that do not themselves form a substantive part of it. Such provisions typically concern matters like the method of tabulation to be used in determining whether a substantive standard is met, the filing of documents, and their admissibility as evidence.¹ General provisions applicable to the whole of an act, however, are not all merely administrative or procedural. They may also relate to the scope of a statute's application either by specifying its constitutional basis or by defining its territorial and extraterritorial application. Part 16 serves all of these ends.

Part 16 specifies the transactions and the conduct to which the Draft Act applies both in terms of Parliament's legislative jurisdiction and in terms of the territorial impact of activities in the securities market. The statute is limited to matters of inter-provincial significance; but once that standard is met it applies to any conduct that is not exempt and that occurs in Canada or has a substantial impact on Canadian investors and thus embodies generally accepted principles of international law. Part 16 therefore makes clear that the Draft Act is intended to deal with all matters that are transprovincial in effect, including those that are initiated outside of Canada but affect the Canadian securities market and Canadian investors. The Part also provides that per-

1 See *e.g.* sections 16.07, 16.09, 16.13.

sons who carry on business or whose securities are traded in Canada are subject to the jurisdiction of Canadian courts. And finally, it prescribes the jurisdiction of the courts to hear cases arising under the Draft Act and the venue for such actions whether civil, criminal or review of Commission action.² Nevertheless, the jurisdiction declared in this Part is not always exercised to the full.³

The validity of the statute depends on its substantive provisions. Although the scheme embodied in the various Parts has been devised to come within Parliament's legislative jurisdiction, constitutional decisions, like all matters of interpretation, are often difficult to predict with certainty. Part 16 therefore includes a severability clause stating that the parts and provisions of the Draft Act may stand independently so that a judicial holding that one of them exceeds Parliament's powers will not bring down the whole statute.⁴ And to facilitate a determination of the Draft Act's intent with respect to any of its provisions, the Part also authorizes a court and the Commission to consider these *Proposals* as an aid to its interpretation.⁵

Section 16.01

Section 16.01 declares, in effect, that the Draft Act is within Parliament's legislative jurisdiction by limiting its application to interprovincial transactions.⁶ The section complements other provisions relating to specific parts of the draft statute and thus provides one of the Draft Act's constitutional bases.

Although the Draft Act as a whole may come within federal jurisdiction as a matter of "general trade and commerce", the limits of the doctrine are not clear.⁷ In fact, their definition may involve consideration of the more traditional criteria for determining Parliament's power such as the application of the legislation to purely intraprovincial transactions or other conduct. The Draft Act therefore, out of caution, ensures that its various parts apply to activities that come within the legislative authority of Parliament. Accordingly, part 5 applies only to interprovincial distributions, part 8 only to persons who carry on an interprovincial business and part 9 only to associations of securities firms that

2 See section 16.05.

3 See e.g. section 6.05 and Commentary.

4 See section 16.17.

5 See section 16.16 and Commentary.

6 See generally, *Anisman & Hogg*, ch. III.B.

7 See *id.* ch. III.B.2.

carry on business in more than one province.⁸ Similarly, the applicability of part 9 to securities exchanges and clearing agencies is premised on their transprovincial character, and part 12 is based upon Parliament's jurisdiction to legislate in respect of criminal law.⁹ The remaining Parts are integrally related to those already mentioned. For example, parts 4 and 7 may be justified either on the basis of "general trade and commerce" or as necessary to support the efficiency and fairness of the securities market and especially of the exchanges upon which the securities of registered issuers are likely to be traded.¹⁰ And the civil remedies and enforcement provisions in parts 13 and 14 are also necessary to effectuate the purpose of the other parts of the Draft Act.

Section 16.01 rounds out this scheme by confining the application of the Draft Act to interprovincial and international transactions. The provision is essential to ensure that none of the Draft Act's provisions includes a trade that occurs within a single province, for their application to *both* interprovincial and intraprovincial transactions would on a traditional analysis exceed federal legislative authority and result in the invalidity of at least those provisions.¹¹

The effect of the section can best be illustrated by the example of a distribution. Because of the exemption in section 6.05, the prospectus provisions in part 5 apply only to an "interprovincial distribution".¹² Subsection 16.01(1) makes clear that part 5 applies only to the interprovincial trades made in the interprovincial distribution. The intraprovincial trades in the distribution, namely, those involving sales of securities in the issuer's province of incorporation, are not covered but are left to provincial regulation. Although compliance with part 5 in respect of the interprovincial elements of the distribution necessarily involves adequate disclosure of information relevant to all the securities sold, it does not ensure that intraprovincial purchasers receive all of the protection under the Draft Act. Subsection (1) therefore emphasizes the need for some form of cooperative regulatory mechanism if adequate protection is to be assured to all Canadian investors. (A similar analysis applies to the civil liability provisions in part 13.)

The "intraprovincial distribution" exemption in section 6.05 is broader than it need be on jurisdictional grounds alone as it includes a distribution in which all of the securities are sold in one

8 See sections 6.05, 8.07, 9.01 and Commentary.

9 See, *Anisman & Hogg*, chs. III.C, E.

10 See e.g. section 4.02 and Commentary.

11 See e.g. Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978).

12 See section 6.05 and Commentary.

province regardless of the jurisdiction of the issuer's incorporation.¹³ Subsection 16.01(2), however, defines as an interprovincial trade the issue of a security by an issuer incorporated in one province to a person in another province.¹⁴ As a result, an exempt "intraprovincial distribution" may consist of interprovincial trades. The effect of the two provisions taken together is that the distribution is exempted from part 5 by section 6.05 but that the interprovincial trades are nevertheless subject to the applicable civil liability and enforcement provisions in parts 13 and 14 as are other interprovincial transactions exempted from part 5 by part 6.

It must be conceded that the analysis of interprovincial trading in connection with a distribution upon which subsection (2) is premised has not been considered by the courts. If it is not accepted by the courts, the subsection can easily be severed, by amendment or otherwise, and the remainder of the Draft Act would likely stand.¹⁵

The *ALI Code* expressly deals with the applicability of state laws to matters covered by it.¹⁶ The Draft Act does not do so as Parliament does not have clear powers of preemption like those of Congress.¹⁷ Instead it leaves the appropriate division of administrative supervision to the provincial and federal governments and to the courts.¹⁸

Section 16.02

Section 16.02 establishes the scope of the application of the Draft Act subject to the general limits specified in section 16.01. Although the primary purpose of the section is to prescribe the statute's application in cases with extraterritorial elements, in doing so the provision also encompasses transactions and conduct occurring exclusively in Canada. Thus any conduct or transaction that falls within a provision of section 16.02 is subject to the substantive requirements specified in the other parts of the Draft Act.

Although the major legislative model for section 16.02 is the *ALI Federal Securities Code*, the approach in the section embodies the recommendations in *Hebenton & Gibson*; it is broadly drafted with specified exceptions, and it incorporates the territoriality and impact principles of international law as well as aspects of the

13 See *id.*

14 See *Anisman & Hogg* at nn. 135-35a.

15 See section 16.17 and Commentary.

16 See *ALI FEDERAL SECURITIES CODE*, s. 1904.

17 See *Anisman & Hogg* at nn. 476-81.

18 See *id.* chs. III.H, I; and see sections 15.06, 15.07 and Commentary.

nationality principle and it usually requires a significant connection with Canada.¹⁹

The *ALI Code* contains the extraterritorial application of its provisions "within the limits of international law" to reflect the principle of statute interpretation requiring that a statute be read, if possible, as not being in conflict with the precepts of international law, and also to allow the courts to determine its scope in the context of international law.²⁰ The Draft Act does not include the phrase in section 16.02 because the principle of interpretation will be applied to the section without it.²¹ In any event, as the section is largely a declaration of international law principles, the inclusion of the phrase would be redundant and might create uncertainty.²²

Paragraphs (1)(a), (c) and (d) deal with conduct that takes place, or has a substantial impact in Canada regardless of where it originates, or of where its constituent acts are performed. Paragraph (1)(a) embodies the territorial principle of international law; obviously trades or solicitations initiated outside of Canada but completed in the country should be covered.²³ Because of the wide definition of "trade", which includes sales and purchases and any act in furtherance of either, the paragraph has a broad scope and would include, for example, a takeover bid or a recommendation in favour of a bid.²⁴ Recommendations opposing acceptance of a takeover bid would be "inducements to hold".

Paragraph (1)(c) involves another application of the same principle. It is included to make clear that an attempted violation of the Draft Act that is aborted, regardless of where it is initiated, falls within the act's provisions, as is already the case with conspiracy under the Criminal Code.²⁵ As a result, paragraph (1)(c) may include conduct that does not involve any overt acts in Canada.²⁶ Conspiracy is not expressly included because it is covered by the Criminal Code.²⁷

19 See *Hebenton & Gibson*, ch. VII.

20 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, ss. 1604(a)-(c), Comment (10); see generally Curtis, *The Extraterritorial Application of the Federal Securities Code: A Further Analysis*, 9 CONN. L. REV. 67 (1976).

21 See e.g. R. WILSON & B. GALPIN, MAXWELL ON THE INTERPRETATION OF STATUTES 142 (11th ed. 1962); cf. *Trendtex Trading Corp. v. Central Bank of Nigeria*, [1977] 1 Q.B. 529, 554, 578-79 (C.A.) (principles of international law automatically incorporated into local law); but see *Thai-Europe Tapioca Service Ltd. v. Government of Pakistan*, [1975] 1 W.L.R. 1485 (C.A.).

22 Cf. *Hebenton & Gibson*, chs. I-VII.

23 See *id.* at nn. 62-76, 146-56 and following; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, ss. 1604(a)-(c), Comment (3)(b).

24 See section 2.48.

25 See Criminal Code, ss. 423(2)(a), 423(4).

26 Cf. *D.P.P. v. Stonehouse*, [1977] 2 All E.R. 909 (H.L.).

27 See Criminal Code, ss. 423(3)-(6).

Paragraph (1)(d) adopts the impact principle of international law that has been broadly applied by courts in the United States under the U.S. securities laws.²⁸ The adverbial phrase at the end of subparagraph (1)(d)(ii) is included to make clear that a defendant need not intend that the consequences of his act have an impact in Canada.²⁹ Rather, the provision imposes an objective test regarding the impact. The subjective element required under the Draft Act as a basis for liability applies only to the acts done and has no connection with the question of jurisdiction.

Subparagraph (1)(d)(i) should also be read broadly. Although the element of a violation that occurs in Canada must be significant, it need not be an essential part of the commission of the violation itself. Thus the provision probably includes negotiations in Canada for a fraudulent sale of a security consummated in New York even though the misrepresentation is made only in New York.³⁰

Subsection (2) goes a step further and deals with conduct outside Canada of a Canadian issuer or one of its subsidiaries. The experience of Investors Overseas Services Ltd. demonstrated that the integrity and reputation of the Canadian securities market requires that improper conduct not be permitted by a Canadian issuer even if its total impact is felt outside of Canada.³¹ Given the scope of the subsection, it is clear that foreigners who suffer harm as a result of a breach of the Draft Act have standing to sue under it.³²

An issuer that sells its securities outside of Canada is not required to register under part 4.³³ It must, however, comply with part 5 and file a prospectus unless it obtains an exemption from the Commission and in any event it is subject to the anti-fraud, civil liability and enforcement parts of the Draft Act. (In this regard the subsection is broader than the source provision which is limited

28 See, *Hebenton & Gibson*, chs. IV.A.3, VII.B.2-3; and see e.g. *Des Brisay v. Goldfield Corp.*, 549 F.2d 133 (9th Cir. 1977) (Canadian plaintiffs brought action in the United States based on takeover in Canada that had adverse impact on U.S. investors in defendant corporations listed on the AMEX).

29 See, *Hebenton & Gibson* at n. 195; cf. *D.P.P. v. Stonehouse*, *supra* note 26, at 915 (per Lord Diplock).

30 Cf. ALI FEDERAL SECURITIES CODE, ss. 1905 (a)-(c), Note (2); *SEC v. Kasser*, 548 F.2d 109 (3d Cir. 1977).

31 See e.g. *Hebenton & Gibson* at nn. 143-44, n. 191 and following; and see *id.* ch. VII.B.1; cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, ss. 1604(a)-(c), Comment (4).

32 See e.g. R. WILSON & B. GALPIN, *supra* note 21, at 148-52.

33 See paragraph 4.01(b) ("public securityholder" must be resident in Canada), section 4.02.

to civil liability for offences.³⁴) The Commission may thus investigate conduct that falls within the subsection and issue cease trading and freeze orders to prevent improper practices.³⁵ And it is clear that the criminal provisions also apply to such conduct.

Subsection (2) applies to corporate issuers in order to cover a distribution outside Canada on behalf of such an issuer by an agent or subsidiary of the issuer. A similar distribution by an unincorporated issuer that involves conduct in Canada would also be covered under paragraph (1)(a) or subparagraph (1)(d)(i). Although subsection (2) applies to a subsidiary of a Canadian corporation, it is not intended to make foreign subsidiaries of a registrant subject to all of the provisions of the Draft Act. Such persons are expressly exempted in paragraph (3)(a), discussed below, as well as in subsection (2).

Unlike the other provisions of subsection (1), paragraph (1)(b) deals with persons having a specified status under the Draft Act and makes the statute applicable only insofar as it relates to that status.³⁶ Reporting issuers and registrants are not included in the paragraph as they are subject to the Draft Act only if they come within another provision of subsection (1).

It is arguable that an employee of a registrant who works in a foreign office and has no personal connection with Canada, other than the fact of his employment, should not be subject to the Draft Act.³⁷ However, in some circumstances the acts of employees in a foreign office may reflect on the integrity of Canadian regulation. Consequently, employees are included in paragraph (1)(b) in contemplation of the Commission's exercise of its exempting power under section 3.03 under which the Commission may require that such employees meet only the standards of the jurisdiction where they are employed.

The general principle underlying section 16.02 is that all persons who are subject to the Draft Act should be treated alike. Thus reporting issuers, whether Canadian or foreign, are subject to the same disclosure provisions.³⁸ However, in one case the general principle may be questioned. Part 4 of the Draft Act requires an issuer with 300 public securityholders to register, and part 7 imposes disclosure requirements upon such issuers and their insiders. It is clear that these provisions should apply to a foreign issuer who distributes securities in Canada; it is less clear when a

34 See ALI FEDERAL SECURITIES CODE, s. 1905(a)(2).

35 See e.g. *In re Morin Heights Development (Overseas) Limited*, 9 QSC Bull., No. 26, July 4, 1978 (Decision number 5593, June 14, 1978).

36 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, ss. 1604(a)-(c), Comment (5).

37 Cf. *Hebenton & Gibson*, ch. VII.C.3.

38 See, *Hebenton & Gibson*, ch. VII.C.1.

foreign issuer does not so distribute its securities. Nevertheless it is possible, in fact likely, that sufficient Canadians will purchase securities of some foreign corporations, possibly on foreign stock exchanges, to make them subject to the registration requirements of part 4. The appropriate solution involves consideration of a number of factors and is not easily resolved. The Draft Act therefore leaves the question to regulations made by the Commission pursuant to subsection (4). It is expected that the Commission will adopt a system like that recommended by Hebenton and Gibson, modified if necessary in the light of its experience, and that foreign issuers will be permitted to file with it the equivalent documents, if any, required to be filed in their home jurisdiction.³⁹ As most such issuers are likely to be actively traded in the United States and subject to the disclosure requirements of the Securities Exchange Act of 1934, this solution would be eminently practicable.⁴⁰

Subsection (3) expressly excepts from the registration requirements of the Draft Act professional market actors who do not have a substantial connection with Canada.⁴¹ It is clearly not necessary to require registration of a nonresident broker who does not carry on business in Canada. Paragraph (3)(a) extends the exception to permit nonresident brokers to conduct business in Canada only to service a non-Canadian client who is temporarily in the country, possibly on vacation.⁴² The paragraph carries a negative implication that reinforces the provisions of subsection (1); any broker who does carry on business in Canada must register. Although the interpretation of carrying on business *in Canada* is left to the Commission and the courts, it is likely that it would include a broker who trades only with foreigners from an office in Canada.⁴³

Section 16.02 is broadly drafted and applies without distinction to the criminal and civil provisions of the Draft Act. As a result, it may be necessary to modify its requirements in specific classes of cases, and the Commission may do so under its general exempting power in section 3.03. Conversely, the Commission may deny an exemption granted under subsection (3).⁴⁴

Subsection (5) makes clear that any power that the Commission has under the Draft Act may be exercised in or outside

39 *See id.*; and see section 7.18 and Commentary.

40 *Cf.* Securities Exchange Act of 1934, Rule 12g3-2.

41 *See, Hebenton & Gibson*, ch. VII.C.2.

42 *Cf.* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, ss. 1604 (a)-(c), Comment (8).

43 *See* sections 16.02(1)(a), (d)(i); *cf.* Quebec Securities Act, s. 50; Gregory & Co. Inc. v. Quebec Securities Commission, [1961] S.C.R. 584.

44 *See* section 3.04 and Commentary.

Canada. The provision is included primarily to enable the Commission to conduct investigations of violations with international elements and to pursue by other means persons who violate the act from outside the country.⁴⁵ As a result, extraterritorial elements are expressly referred to elsewhere in the Draft Act only when they deal with a standard to be applied.

Section 16.03

Sections 16.01 and 16.02 deal with the application of the substantive provisions of the Draft Act. Section 16.03 and the sections following it are directed at jurisdiction of the courts and the Commission to deal with conduct to which the legislation applies. Thus section 16.03 requires the filing of a consent to service and to jurisdiction by foreign issuers that desire to distribute securities in Canada or to register under part 4 and by nonresident applicants for registration, and similar requirements are applicable to their officers and directors. The provision is intended to ensure that a Canadian court has jurisdiction that is likely to be recognized by a foreign court in an action against the specified persons.⁴⁶ Paragraph (3)(b) therefore declares that a consent to service involves consent and submission to jurisdiction.

The provincial commissions follow the practice of refusing to accept a prospectus until an issuer and its directors agree to comply with the continuing disclosure provisions of the local securities act.⁴⁷ This approach is not adopted in the Draft Act because the Commission may prescribe registration requirements applicable to foreign issuers who become subject to part 7 upon filing a registration statement.⁴⁸ And paragraph (1)(d) is sufficient to require insiders other than major securityholders to comply with the Draft Act. Even though the requirements of the section could be imposed by the Commission as conditions on registration, it is preferable as a general matter to include them in the statute, especially in light of the increasingly international character of the securities markets.

Section 16.04

Section 16.04 authorizes the Commission to make regulations requiring nonresidents to deposit assets in Canada as a method of

45 See e.g. section 14.08; and see generally part 14.

46 See, *Hebenton & Gibson* at nn. 196, 327-28.

47 See *id.* nn. 157-62 and following.

48 See subsection 16.02(4).

facilitating enforcement of the Draft Act.⁴⁹ Similar requirements are applicable to registrants, but not to issuers, under the provincial securities acts.⁵⁰ And the Commission may impose such requirements under parts 4, 5 and 8 of the Draft Act. Nevertheless, it is likely that the Commission will find the express power in section 16.04 useful once it acquires experience with nonresidents.

Section 16.05

Section 16.05 gives the courts jurisdiction to entertain criminal and civil actions under the Draft Act and to hear appeals and other applications for review of the Commission's orders and regulations. It also prescribes the venue for such proceedings.

The section relies on the definition of "superior court" in the Interpretation Act, s. 28, which includes the courts of superior jurisdiction, that is, the trial division and court of appeal, however called, of each province and the territories and the Federal Court of Canada.⁵¹ Thus an action under the Draft Act may be initiated in the trial division of any superior court in Canada prescribed by the venue provisions. In result, the Federal Court and provincial superior courts have concurrent jurisdiction in civil matters.

Subsections (3) and (4) follow the appeal provisions in part 15 and give the provincial superior courts and the Federal Court concurrent jurisdiction over appeals and applications for review of Commission action.⁵² Subsection (3) follows the pattern in the federal and provincial legislation and limits appeals to the appellate division of the provincial superior court and to the Federal Court of Appeal, and subsection (4) permits applications for review of decisions of the Commission that are not subject to appeal to be made to the appropriate division in each jurisdiction. The Federal Court thus has concurrent jurisdiction over civil and administrative actions with which it has substantial experience.⁵³

However, as the Federal Court does not ordinarily exercise jurisdiction in criminal proceedings, subsection (5) limits such actions under the Draft Act to the provincial superior courts. The venue provisions of the section are unremarkable. Paragraph (5)(a) restates the common law principle of venue and paragraph

49 See *Hebenton & Gibson* at nn. 61, 318-21; *cf.* *Owners of cargo lately laden on board the vessel Siskina v. Distos Compania Naviera SA*, [1977] 3 All E.R. 803 (H.L.).

50 See *e.g.* Ontario Securities Regulations, ss. 6(1) (minimum capital requirements), 6(3) (bonding requirements).

51 See Federal Court Act, s. 64(2) (where "Exchequer Court of Canada" used, substitute "Federal Court of Canada").

52 See sections 15.19, 15.20 and Commentary.

53 See *e.g.* Federal Court Act, ss. 18, 29; *cf.* Combines Investigation Act, R.S.C. 1970, c. C-23, s. 31.1, added by S.C. 1974-75-76, c. 76, s. 12.

(5)(b) extends it and the Criminal Code to include the territory in which an accused resides or carries on business. The latter provision derives from the Combines Investigation Act, s. 44.1, and is less stringent than analogous sections in some Canadian statutes.⁵⁴

Subsection (2) specifies the venue for an application to require compliance with an order of the Commission made in connection with an investigation under section 14.01 or 14.02. As such orders will usually involve enforcement of a subpoena, compulsion of testimony or production of documents, they may be enforced only where the person who is subject to them resides or carries on business, rather than where the investigation is being conducted, in order to avoid imposing unnecessary expense on a reluctant witness.⁵⁵

Finally, subsection (7) authorizes the body responsible for the rules of practice and procedure in the provincial superior courts and in the Federal Court to make rules to provide for the transfer, stay and consolidation of impersonal actions under part 13. The provision is necessary to enable the implementation of the solution developed by the Commission in conjunction with the Canadian Judicial Council, the provincial superior courts and the Federal Court to ensure that the ceiling on damages in such actions does not result in recovery only by the persons who are first to bring an action.^{55a} Consolidation of actions brought in more than one province is therefore expressly made possible.

Section 16.06

Section 16.06 results from the distinction between jurisdiction over the subject matter of an action and jurisdiction over the person who is responsible. While section 16.05 deals with subject matter jurisdiction, this section authorizes service of process on a defendant in a civil action and on an accused in summary conviction proceedings, including service outside of Canada. The section reinforces the application of the Draft Act to violations initiated outside Canada that affect the Canadian securities market and Canadian investors. In light of the increasing internationalization of the securities markets, it is likely to be used with some frequency. Subsection (1) provides a uniform rule for extraterritorial

54 See e.g. Animal Contagious Diseases Act, R.S.C. 1970, c. A-13, s. 47 (where offence arose or any place where accused "happens to be"); Income Tax Act, S.C. 1970-71-72, c. 63, s. 244(3).

55 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1518(b), Comment (1); but see ALI FEDERAL SECURITIES CODE, s. 1822(c).

55a See section 13.04, Commentary.

service of process in a civil action so that the Draft Act is equally enforceable throughout Canada, regardless of any differences among the procedural rules of the provinces concerning service out of the jurisdiction. Finally, subsection (2) rebuts the presumption of territoriality in relation to the service of a summons.⁵⁶

A similar provision is not included in relation to warrants for the arrest of a person accused of violating the Draft Act because Criminal Code, ss. 455(b) and (c) authorize the issue of a warrant regardless of the jurisdiction in which an accused person is found, so long as the offence was committed within the territorial jurisdiction of the justice before whom the information is laid. If the accused is outside Canada, the execution of such a warrant involves his extradition pursuant to the applicable treaty.⁵⁷

Section 16.07

Section 16.07 authorizes the Commission to make regulations in relation to the formalities of filings with it.⁵⁸ Paragraph (a) permits the Commission to designate by regulation the persons required to sign a filing. The provincial securities acts themselves specify who must sign such documents but, as the persons required to sign a filing may vary with the nature of the document filed and as the signing is essentially a formality to ensure proper authorization, the matter is more appropriately left to regulations. This approach is reinforced by the fact that under the Draft Act, unlike the present Canadian legislation, liability is not based upon the signatures on the filing; rather the persons who are liable are specified in the provisions of part 13. In fact it is expected that the Commission will require all documents to include the names of persons holding the offices to which liability attaches under part 13.⁵⁹

Similarly, paragraph (d), which gives the Commission power to require the consent of an expert to the inclusion of his name or report in a filing, is an adaptation of the provisions in provincial legislation.⁶⁰

There may be some overlap between these provisions and the regulations authorized by paragraph 15.14(1)(b) in that the required signatures and consents might be considered part of the contents of filed documents. Nevertheless, these matters are suffi-

56 See *e.g. Re Shulman*, 23 C.C.C. (2d) 242, 247 (B.C.C.A. 1975).

57 Cf. subsection 15.12(4).

58 See section 2.20 ("filing").

59 Cf. ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1702(c)(1), Comment (2).

60 See *e.g.* Ontario Securities Act, s. 50; *cf.* Canada Business Corporations Act, s. 196; ALI FEDERAL SECURITIES CODE, s. 2003(e).

ciently important to merit separate treatment and their express inclusion in this section puts the Commission's authority beyond doubt.

Paragraph (c) requires little explanation. The Draft Act itself, like the Canada Business Corporations Act, requires that a copy of a takeover bid circular be sent to the directors of an offeree issuer.⁶¹ Paragraph (c) authorizes the Commission to make regulations requiring similar delivery of filed documents to other persons that it thinks should receive them. It may, for example, require that reports of trades by insiders or accelerated insider reports be sent to the issuer, that filings by reporting issuers be sent to the exchange on which they are listed or that a filing by a person subject to the jurisdiction of another regulatory agency be sent to it. Subparagraph (iii) is also intended to facilitate cooperation by the Commission with the provincial securities commissions and with its foreign counterparts.

Section 16.08

Section 16.08 is straightforward. It provides that all filed documents shall be available to the public unless they fall within a class that the Commission designates by regulation as confidential. The rule-making power in subsection (3) is parallel to the power of the provincial commissions and of the federal Director of Corporations to grant exemptions from the financial disclosure requirements.⁶² Presumably any information designated confidential under this section would come within the prohibition in section 15.23 against the use of confidential information by Commission employees. If the Commission denies an application for confidential treatment under subsection (3), its order is subject to judicial review pursuant to section 15.19.

Subsection (4), following section 260 of the Canada Business Corporations Act, expressly permits the Commission to maintain filings in an information storage system that is mechanically or electronically operated. It is complemented by the second clause of subsection (2). The subsection enables the storage of filed information on computers and may serve to facilitate the dissemination of information on a nationwide basis for purposes of disclosure and investor decision-making.⁶³ The admissibility of such filings in evidence is dealt with in subsection 16.09(2).

61 See section 7.24.

62 See e.g. Canada Business Corporations Act, s. 150; cf. SECRETARY OF STATE, LEGISLATION ON PUBLIC ACCESS TO GOVERNMENT DOCUMENTS 11 (1977).

63 See generally, Hall.

Section 16.09

Section 16.09 is intended to facilitate proof of facts concerning the filing of documents with the Commission and the status of persons required to register and proof of other facts relating to the administration of the Draft Act. Like the Ontario source provisions, subsection (1) makes a certificate of the Commission admissible in evidence but does not specify the weight to be given it so that it creates, in effect, a rebuttable presumption of the truth of the certificate. The provision thus varies from the Canada Business Corporations Act which makes a certificate “conclusive proof of the facts certified”.

Section 16.10

As Professor Loss indicates, it would be unfair to require a person to publish a statement and then hold him liable for it.⁶⁴ Section 16.10 is intended to contain such potential liability within reasonable limits. It precludes liability for a defamatory statement made in compliance with the Draft Act or the by-laws of a registered self-regulatory organization unless the defendant knew of or was reckless regarding the falsity of the statement. The section is narrower than the equivalent provincial provisions which, on a literal reading at least, absolutely preclude such liability. Subsection (2) thus permits a plaintiff to recover if he can prove “malice” to overcome the qualified privilege under subsection (1). And subsection (3) is included to deal with the situation where a defendant is required by the Commission to include in a filing a statement that he knows or suspects is defamatory.⁶⁵

The provincial legislation also exculpates from liability a person who commits any act or omission in compliance or intended compliance with the statute.⁶⁶ The Draft Act is more limited, at least with respect to damages resulting from compliance with its provisions by persons other than the Commission’s staff.⁶⁷

Section 16.11

Section 16.11 grants employees of a registered self-regulatory organization immunity from civil liability similar to that granted to commissioners and Commission employees under section 15.22.

64 See ALI FEDERAL SECURITIES CODE, ss. 2008(a)–(b), Note.

65 See ALI FEDERAL SECURITIES CODE, Tent. Draft No. 3, s. 1705, Comment (3) (example of such a case involving a Canadian corporation that was sued for libel).

66 See *e.g.* Ontario Securities Act, s. 145(2).

67 Cf. sections 15.22, 16.11.

Nevertheless, the section is framed differently than the earlier one. Under section 15.22 a plaintiff must allege and prove that a defendant acted in bad faith, whereas section 16.11 provides a defence to an action. It is clear, therefore, that a defendant has the burden of proving that he fulfilled the standard specified in the section.⁶⁸

The provision in the *ALI Code* exculpates a self-regulatory organization as well as its employees from liability. For some time apprehension of liability for defamation, or at least an action for defamation, deterred the City Panel on Take-overs and Mergers and the London Stock Exchange from publishing the results of their investigations into alleged insider trading and thus hampered the effectiveness of self-regulation in Britain. However, the self-regulatory bodies in Britain accepted the challenge and now publish their findings, apparently without detriment. The advisers therefore concluded that self-regulatory bodies registered under the Draft Act are not exposed to serious risk of liability and should be treated like the Commission itself. Accordingly they are not granted statutory immunity from liability.

Section 16.12

Section 16.12 parallels the requirement that the Commission maintain its files for a period of six years and is included so that investors and the Commission may have access to documents required to be maintained under the Draft Act for enforcement or other purposes. The Commission may shorten or lengthen the period as it thinks necessary and may also grant an exemption from it under the general exempting power in section 3.03.

Sections 16.13 and 16.14

Sections 16.13 and 16.14 are intended to facilitate compliance with the Draft Act. Section 16.13 enables a person to determine with relative ease whether he is required to make a filing or perform another duty under the Draft Act. An issuer may, for example, rely on its securities register to decide whether it must file a registration statement under part 4.⁶⁹ And a securityholder may also rely on it or on a list obtained through a clearing agency under section 10.15 when determining whether he is obligated to file an insider report under section 7.13. Subsection (2) is derived

68 Cf. ALI FEDERAL SECURITIES CODE, s. 2008(d) and Note.

69 See paragraph 4.01(b), section 4.02.

from the Canada Business Corporations Act and is included for similar reasons.

Section 16.14 similarly generalizes the source provisions and extends the presumed receipt of a prospectus in the ordinary course of the mails to all documents sent pursuant to the Draft Act. Because the presumption applies on an act-wide basis, it is not conclusive as in the source provisions but may be rebutted by the person to whom a document is sent. The provision thus approximates the common law.⁷⁰

Section 16.15

Section 16.15 declares expressly that the Draft Act applies to the federal and provincial governments.⁷¹ Securities issued by those governments are therefore subject to the Draft Act unless exempted.⁷² Consequently persons who trade in them must comply with the anti-fraud provisions in part 12.

Section 16.16

This section prescribes principles for the interpretation of the Draft Act that supplement those in the Interpretation Act. The Interpretation Act, s. 10, requires that all statutes be interpreted to effectuate their purpose, and courts have long looked to reports of committees to determine the "mischief" with which a statute under consideration was intended to deal.⁷³ Recently the English Law Commission has suggested that such reports, but not parliamentary proceedings, should also be considered as an aid to the interpretation of the specific provisions of a statute.⁷⁴ The House of Lords, while affirming the use of such reports to determine statutory purpose, divided on the question of whether they should also be used to discern the meaning.⁷⁵ (However, all but one of the Law Lords held that the proceedings before Parliament should not be considered to determine meaning. Lord Simon of Glaisdale left open the question of consideration of parliamentary proceedings when the draft provisions in a report are altered in the

70 See *e.g.* *Teichberg v. D.H. Blair & Co.*, 314 N.Y.S.2d 284 (S.C. 1970).

71 See section 2.30, Commentary.

72 See *e.g.* paragraph 3.02(1)(a).

73 See *e.g.* *Laidlaw v. Metropolitan Toronto*, 20 N.R. 515, 522-27 (S.C.C. 1978); *Green v. Charterhouse Group Canada Ltd.*, [1973] 2 O.R. 677, 734-35 (Ont. H.C. 1973).

74 See LAW COMMISSION AND SCOTTISH LAW COMMISSION, *THE INTERPRETATION OF STATUTES*, ¶ 52 (1969).

75 See *Black-Clawson International Ltd. v. Papierwerke Waldhof-Aschaffenburg A.G.*, [1975] 1 All E.R. 810.

legislature.⁷⁶) Nor is the question foreclosed to the judiciary in Canada. At least one eminent Canadian jurist has stated that the recent decisions of the House of Lords open "up possibilities for the re-examination of Canadian case-law".⁷⁷ Moreover, the Evidence Code recommended by the Law Reform Commission of Canada would permit judicial notice to be taken of all of the above matters, including proceedings in Parliament.⁷⁸

As statutory interpretation is intended to effectuate the intent of legislation enacted by Parliament, it makes little sense not to consider any materials that may be helpful in ascertaining that intent. Subsection (1) therefore adopts the more progressive judicial position and makes clear that legislative history is relevant and admissible to determine both the purpose of the Draft Act and the meaning of its provisions. It thus specifies not only the *Proposals* and other reports relating to the Draft Act presented to Parliament during its consideration of an act based on them, but also the published proceedings of Parliament and of parliamentary committees which may reveal the reasons for alterations made to provisions of the Draft Act before Parliament.

Subsection (2) is somewhat more novel. It is not uncommon for courts to interpret legislation enacted as a result of a treaty to effectuate the treaty's terms.⁷⁹ Subsection (2) goes further and requires that the Draft Act be interpreted where possible to give effect to the terms of any treaty relating to trading in securities that Canada enters into.⁸⁰ In light of the increasing internationalization of the securities markets, it is probable that Canada will be involved in the negotiation of treaties on this subject in the future. Indeed, one of the express purposes of the Draft Act is to enable Canada to deal adequately with international securities matters.⁸¹ The interpretative principle in subsection (2) is intended to further the attainment of these ends.

Section 16.17

Although there is a good basis for believing that all of the Draft Act is within Parliament's legislative jurisdiction, decisions

76 See *id.* at 843. And see RENTON REPORT, ¶19.23 (recommending that matter be dealt with expressly in individual statutes).

77 Laskin, *English Law in Canadian Courts Since the Abolition of Privy Council Appeals*, 29 CURRENT LEGAL PROBLEMS 1, 21 (1976).

78 See LAW REFORM COMMISSION OF CANADA, REPORT ON EVIDENCE, Evidence Code, s. 84(2)(a)(1975). And see *Laidlaw v. Metropolitan Toronto*, *supra* note 73, at 525-27.

79 See *e.g.* LAW COMMISSION, *supra* note 74, ¶¶ 74-76.

80 See RENTON REPORT, ¶¶ 19.22, 19.27-19.28 (recommending similar provision).

81 See paragraph 1.02(f); *cf.* subsection 15.12(4); and see generally, *Hebenton & Gibson*, chs. VIII-XI.

of the courts on constitutional questions cannot be predicted with certainty. As the various parts of the Draft Act will not rest on the same constitutional foundation, it is advisable to include a severability provision so that if one part of the Draft Act is declared invalid the other parts will continue in effect.⁸² This result is especially important in light of the fact that the provisions of the Criminal Code dealing with market manipulation are likely to be abrogated by part 12 should the Draft Act come into effect.

82 See *Anisman & Hogg*, ch. III.G.

